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OF THE FOURTH ANNUAL

Institute on Accounting

Held At

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MAY 16 AND 17, 1941

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THE DEPARTMENT OF ACCOUNTING
COLLEGE OF COMMERCE AND ADMINISTRATION
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PREFACE

On May 16 and 17, 1941, the Department of Accounting had the pleasure of welcoming members of the accounting profession to the Fourth Annual Institute on Accounting at The Ohio State University.

A tabulation of the registration cards disclosed that 363 people were registered. Many others attended the sessions but did not register.

An analysis of the registration by professional connection follows:

Public accountants	102
Industrial accountants	120
Public officials	11
College instructors	68
Students	62
Total registrations	363

Of those present at the Fourth Annual Institute on Accounting, 139 attended for the first time, 69 had attended a previous institute, 52 had attended two previous institutes, and 41 had attended all four annual institutes. Students have not been included in these figures.

The Department wishes to express its appreciation to those whose efforts contributed so much to the success of the Institute.

The Department of Accounting

August, 1941

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FIRST SESSION

FRIDAY, MAY 16, 1941 — 10:30 A. M.

Commerce Auditorium

Chairman:

LEONARD PARK, *C.P.A., Peat, Marwick, Mitchell and Company, Cleveland; President, The Ohio Society of Certified Public Accountants*

Subject: "Accepted Accounting Principles"

Papers:

HENRY T. CHAMBERLAIN, *C.P.A., Loyola University, Chicago; President, The American Accounting Association*

WILLIAM W. WERNTZ, *Chief Accountant, Securities and Exchange Commission, Washington, D. C.*

INTRODUCTORY REMARKS

By Leonard Park, *C.P.A.*
Peat, Marwick, Mitchell & Co., Cleveland;
President, The Ohio Society of Certified Public Accountants

Members of the Fourth Annual Institute on Accounting: The increased attendance at these meetings shows the interest taken in them, and a review of the program clearly indicates that the standards of previous years will be maintained at this meeting. It is the belief of the Society of Certified Public Accountants of the State of Ohio that this should be one of the leading states in the accounting profession and such meetings help to gain for us that recognition. On behalf of the Society I wish to extend the gratitude of its members to the Ohio State University and to the College of Commerce for permitting us to participate in these proceedings.

This first session will be devoted to a discussion of "Accepted Accounting Principles," a subject very much in the foreground recently, and one in which everyone will be interested. We have two speakers who are well qualified to handle the subject. The first speaker, Henry T. Chamberlain, is the Dean of the School of Commerce at Loyola University, and member of the American Institute of Accountants and President of the American Accounting Association. He has been extremely active in accounting work. Mr. Chamberlain.

ACCEPTED ACCOUNTING PRINCIPLES

By Henry T. Chamberlain, *C.P.A.*
Loyola University, Chicago; President,
The American Accounting Association

When I received the invitation to speak at this meeting on the subject of "Accepted Accounting Principles," my first thought was that a question mark at the end of the topic had, inadvertently, been omitted. Then, recalling the many published reports I had examined in the last few years in which the certifying accountant reported that the accounts were prepared in accordance with "accepted principles of accounting," I concluded that the topic was not intended to be stated as a question—that there must be such things as accepted accounting principles, and that I would be expected to talk on that subject.

For some years, writers in the field have assured us that there are accounting principles; they have assured us that these principles are known to accountants; and we have been told that these known principles have been accepted by accountants. Now, if these known principles have been accepted by accountants, it would seem that we should be able to identify them in the published reports of corporations, which bear the stamp of approval of members of the profession. However, a search for *accepted* principles in those reports will prove fruitless, I am afraid. Consider what we find:

Fixed assets carried at cost or written up or down to reflect so-called current replacement values, with no indication of the original cost; reserves for depreciation and the related depreciation charges computed on the basis of cost or replacement values; natural resources shown with or without reserves for depletion, and in those cases where the reserves are shown the related charges may be made against income or on unrealized surplus; inventories carried at cost, cost or market value whichever is the lower, or market value; treasury stock carried as an asset or deducted from capital; discount on stock shown as a deferred charge or as a deduction from capital stock; large losses carried as deferred charges to be gradually amortized, or written off immediately to surplus or profit and loss; and so-called capital gains and losses taken to profit and loss or surplus.

This list is by no means exhaustive but is presented only as a sample of the divergent practices that are said to conform to accepted principles.

of accounting. If you ask how these divergent practices march side by side, though appparently out of step with one another, and all be said to conform to accepted principles of accounting, you will receive from one group an answer that is far from helpful. You will be told that accounting cannot be reduced to stated rules or standards; that accounting principles are an admixture of customs, conventions, sound business judgments, expert opinion and discretion; that what you regard as violations of accounting principles are not, in fact, violations at all, but simply your failure to understand all the surrounding circumstances.

In contrast to this view, others in the profession today hold that accounting principles are not quite so mysterious; that accounting principles can and should be stated in understandable language for guidance and reference; and that the qualities of expertness and discretion possessed by the experienced accountant should be distinguished from accounting principles. This group has never taken the position that accounting is an exact science—that a charge for depreciation, depletion or obsolescence could be measured precisely. But that such charges should be made in the calculation of net income they have never doubted. They have consistently held that there is great need for a statement of principles, and that this statement should come from the profession rather than from the SEC or other governmental agency.

In furtherance of this latter view, the Executive Committee of the American Accounting Association published in the June, 1936, issue of the *Accounting Review* its "Tentative Statement of Accounting Principles Underlying Corporate Financial Statements." This pronouncement, containing twenty propositions, was an attempt to put into definite form what the committee regarded as basic for the proper presentation of accounting statements. Criticisms of the document were widely solicited, but it must be reported that they were few in number and, for the most part, not very constructive. In large part, they were concerned with the propriety of calling certain numbered paragraphs "principles" rather than corollaries or rules, or fretting over the use of the words "value" and "valuation," and attempting to interpret the use of those words as contradictions of the fundamental thesis.

Since the publication of that document, five years ago, the Executive Committee of the Association has had before it, constantly, the subject of principles; it has reviewed all the criticisms of the document and has given close attention to the other published material on the subject. Now the committee is preparing to issue a revision of the original pronouncement. I had hoped that the work of the committee would be far enough along at this time to enable me to present the revised document to this Institute, but unfortunately that is not the situation. Since the first of this year, four complete drafts of the revision have been prepared, and the fifth is now in process. However, I can tell you something of the thought of the committee, and give you some indication of the form that the finished product will take.

The original document has been condensed into three principles: (1) The cost principle; (2) the income statement principle; and (3) the capital principle. Following each of these principles (and others which will be added) is a series of applications which are intended as explanations of the committee's views, or which point to matters that have been the subject of recent attention.

THE COST PRINCIPLE

Assets acquired (costs incurred) through the outlay of cash or its equivalent should be carried in the statements at cost, less whatever allowance is necessary to reflect accrued depletion, depreciation, obsolescence, or other expiration or loss of useful or recoverable cost; liabilities representing the receipt of cash or its equivalent should be carried in the statements at the amount of the proceeds, with adjustments of discount or premium from period to period to reflect the approach of maturity; stockholders' equity should be carried at the amounts paid in by stockholders or contributed by others plus or minus the cumulative results of operations and distributions.

Applications of the Cost Principle

1. Cost is measured by cash outlay or by the fair market value of other considerations. Assets which are donated to an enterprise should be carried in the accounts at the fair market value at the time of contribution, all available evidence being taken into account in the determination of such value.
2. Periodically, it must be determined what part of cost has been consumed, has expired, or has lost its usefulness, and what part should be carried forward in the balance sheet as reasonably applicable to future operations. Since diminutions or partial expirations of cost are frequently not subject to precise measurement, estimations of costs applicable to the past and to future periods must be based upon business judgments, seasoned experience, and expert opinion, rather than upon rigid formulae. In each enterprise and each industry, reasonably consistent practices should be developed for this purpose.
3. Costs applicable to assets no longer useful or salable should be eliminated from the balance sheet, and the portion of costs at which assets in use or ultimately to be marketed are carried on the balance sheet should not exceed such amounts as, in the light of all available evidence, may reason-

ably be assigned to future operations. Depreciation, depletion, and obsolescence must invariably be calculated with due recognition of remaining useful life.

4. Since the records of many enterprises do not permit an accurate determination of the cost of some older assets still in use, the application of these principles may have to date from a selected point of time rather than cover all past transactions. Consistent application of these principles over a period of years will eventually yield financial statements in which the asset figures derive from the single basis of cost.
5. An excess of the face or gross amount of an obligation over the proceeds received upon its issue represents interest payable at maturity, and on a balance sheet the unaccrued portion of such interest should appear as a reduction of the face value of the indebtedness. Any excess of proceeds over face value constitutes a liability payable from time to time as a part of the nominal interest payments, and on a balance sheet any unpaid portion of such liability should appear as an addition to the face value of the indebtedness.
6. When a liability is retired, either by payment or by refunding, all items related to it should be eliminated from the balance sheet, including unpaid premium, unamortized debt discount and expense, call and retirement expense, and any premium paid to holders.
7. Values other than those arrived at by the application of the cost principle should appear in financial statements only as collateral notations, adequately labeled, and placed in parentheses, inner columns, or footnotes.

The cost principle stated above, together with the examples of its application, is sufficiently definite to provide a common basis for statement procedure. It should be applied with enough flexibility to meet business and financial needs under all ordinary circumstances. A sudden extreme change in the value of money might vitiate the usefulness of cost records, but there is no sound reason for repeated adjustments of asset values for such changes in price levels as have occurred in this country during the last half century. A history of cost and cost amortization is a consistent record of actual occurrences measured according to an intelligible formula, and constitutes an essential starting point in financial interpretation.

THE INCOME STATEMENT PRINCIPLE

The income statement for any given period should reflect all revenues and gains given recognition and all costs written off during the period, regardless of whether or not they are the results of operations in that period, to the end that, for any period of years in the history of the enterprise, the assembled income statements will express completely all gains and losses. Income does not include credits or charges resulting from transactions involving the issuance, purchase, or retirement of the capital accounts; or from dividend payments or stock-dividend distributions.

Applications of the Income Statement Principle

1. The income statement for any given period should be divided into such sections as may be required to show particulars of income from the operations of the current period, measured as accurately as may be at the time, and to show realized capital gains and losses and other credits and charges resulting from income realization and cost amortization not ordinarily associated with the operations of the current period.

   One section of the income statement should disclose the revenue from sales made and services rendered; the elements of operating cost and expense incurred, including the amount of depreciation and other amortization of assets applicable, and any other income produced during the year by assets used in operations. This section may be subdivided or departmentalized in any way desired to show major and minor income-producing activities or other classifications of expense and revenue items.

   The other section or sections of the income statement should list in reasonable detail the so-called capital gains and losses; extraordinary charges and credits to income, including substantial adjustments applicable to but not recognized in prior years; extraordinary gains, losses, and amortization resulting from factors other than current operations; gain or loss from the discharge of liabilities at less or more than their recorded amount; interest on borrowed money, including debt discount amortized during the year; income and profits taxes; and all other items necessary to reconcile earned surplus on the current and preceding balance sheets.
2. In the presentation of income statements covering a series of years, the net incomes of the included years may be recomputed to give effect to major items clearly applicable to years other than those in which they were originally recognized. Such presentation should include a reconciliation of the original and revised statements, showing the details of the adjustments made.
3. Income should not be distorted or artificially stabilized by creating large reserves either by appropriating income or surplus or by overstating expenses in certain periods and subsequently charging to such "reserves" expenses and losses pertaining to succeeding periods. Earned surplus reserved for contingencies or for similar purposes does not lose its character as earned surplus; expenses or losses arising from contingencies thus anticipated should be reflected, not as reductions of the reserve, but in the income statement of the period in which they are recognized.

The objective of the income principle is to develop a report of income for each fiscal period which not only reflects fully the items affecting current results, but also indicates what adjustments have been made for gains or losses which are not strictly applicable to the operations of the current period but which have been recognized in the accounts during that period. If net income is to have any meaning, the factors influencing it must be isolated and given a distinct and unified expression. This is possible if all profits and losses are carried through a single medium to earned surplus.

It is impossible if expense charges, losses, or income credits may be carried directly to various types of "operating" or surplus reserves.

In view of the emphasis given to computations of earnings per share, and to other measures of corporate performance, a common yardstick is demanded. The fact that it is not possible to measure precisely at the end of any year all costs which have been acquired or dissipated during that year makes it important to encompass within a single statement, not only the best possible measure of the year's results, but also the best possible measure of such corrections as seem necessary in the statements made for prior periods.

If material losses or gains recognized during the current period actually apply to earlier periods, either of two alternatives may be adopted: (1) to show the extraordinary charges or credits in the current income statement; or (2) to restate the income statements of the proper number of past periods. If the latter alternative be chosen, the revised statements of past periods should accompany the statement for the current period.

THE CAPITAL PRINCIPLE

Corporate capital consists of two major divisions—paid-in capital, and earned surplus—which should be segregated and clearly differentiated on the balance sheet. No transfers should be made from the former to the latter either directly or indirectly.

Applications of the Capital Principle

1. Paid-in capital is measured by amounts received for shares issued, whether recorded on the books as capital stock, as paid-in surplus, as credits from the reissue of reacquired shares or from the retirement of shares reacquired at a discount, or as transfers from earned surplus to capital stock by means of stock dividends, recapitalizations, or otherwise. It may also include amounts contributed by others than stockholders. Reductions of paid-in capital may arise from the redemption of outstanding shares, retirement of reacquired shares, liquidating dividends, or adjustments in a reorganization or quasi-reorganization.
2. Earned surplus should be credited or charged only with the following: the balance of the income account, as periodically reported; distributions to stockholders; and adjustments resulting from recapitalizations and share retirements. Earned surplus should include no credits from transactions in the company's own stock or transfers from paid-in capital or other capital account.
3. Surplus reserves set aside for such purposes as the protection of working capital or the coverage of sinking funds are subdivisions of earned surplus, and should not be availed of for the absorption of expenses or losses. Charges for all cost amortization, losses recognized, and other asset values expired should be by way of the income account.

4. Where by proper corporate action, including the approval of stockholders, a deficit has been absorbed through a reduction of par or stated value of capital stock or by transfer to paid-in surplus, earned surplus thereafter should be so labeled as to indicate that it dates from the time of the elimination of the deficit.
5. Periodic reports should include in the balance sheet, or as separate statements, analyses of capital stock, surplus and surplus reserves in sufficient detail to disclose the nature of the changes taking place during the accounting period, including increases and decreases in paid-in capital resulting from sales and purchases of shares.
6. The outlay for reacquired shares of capital stock should, if the shares are reissuable, be shown on the balance sheet as an unallocated reduction of capital stock and surplus, and it should be indicated that earned surplus is restricted to the extent of the cost of the reacquired shares. If the shares are not reissuable, or if they acquire the status of unissued or retired shares, such outlay should be charged to the capital-stock account up to the amount by which capital stock has been formally reduced; any balance remaining should be charged to paid-in surplus, if any, up to an amount not in excess of the pro rata portion of the total paid-in surplus applicable to that class of shares; any part of the outlay which cannot thus be absorbed should be charged to earned surplus as constituting a distribution thereof. In case shares are retired at a figure less than their par or stated values, the credit arising should be made to paid-in surplus.

The application of the capital principle is handicapped in some degree by conflicting provisions of corporation laws. It is not necessary, however, to adopt in accounting practice the expedients permitted under any given law. The principle suggested above represents at most some restriction of procedures which may have been legalized but which plainly are not in accord with good acounting and finance.

The objective of these propositions is to make an effective distinction between capital contributed to the corporation and capital accumulated as a result of earnings from operations or from sources other than stock transactions. Attainment of this objective requires that no portion of a stockholder's contribution be credited to earned surplus although the retirement of a stockholder's equity may involve a distribution of earned surplus if the amount of the payment exceeds his *pro rata* portion of paid-in capital.

When capital has been contributed to a corporation for permanent use, or has been dedicated to that use through the issue of a stock dividend, it should not be used later to increase earned surplus, either through absorption of losses or write-offs, or through direct credit. The only exception occurs when a deficit in earned surplus is eliminated through a restatement of capital equities approved by stockholders; and in such cases future statements of earned surplus should designate the point of time from which the new surplus dates.

There you have the substance of the thoughts of the Executive Committee of the American Accounting Association on these three principles, which, possibly with minor changes, will appear in the finished document. I have not attempted to present the views of the committee on one or two other principles which are still the subject of committee discussion.

Only those who indulge in wishful thinking can hope that any statement of accounting principles will constitute the final word on the subject or will satisfy all accountants, but unless the basic concepts of accounting are continuously studied and tested we cannot even hope to approach that goal. I well realize that the above three principles are not universally accepted principles of accounting, but I am convinced that they do have wide acceptance—greater by far than they had when the "Tentative Statement" made its appearance in 1936. I can only hope that the child of the 1936 document, like its parent, will make its contribution to the development of accepted principles.

CHAIRMAN PARK: Our next speaker, William W. Werntz, joined the Securities and Exchange Commission staff as an attorney in 1935. Since 1938 he has been chief accountant for the Commission. He studied at Yale University. It is with great pleasure that I present to you Mr. Werntz.

PROBLEMS IN THE APPLICATION OF ACCEPTED ACCOUNTING PRINCIPLES

By William W. Werntz
Chief Accountant, Securities and Exchange Commission, Washington, D. C.

I should like to discuss the topic "Accepted Principles of Accounting" from the point of view of applying such principles in the work of the Securities and Exchange Commission. Such an approach envisages, I believe, a discussion of the way in which controversies arise in considering the propriety of a particular set of financial statements, and will probably be most fruitful if directed to the causes of disagreement rather than to a mere enumeration of instances in which a difference of opinion has arisen. Controversy, as I see it, stems from two principal sources: (1) the failure to agree on the relevant or operative facts in a given situation; and (2) the failure to agree on the rules, standards or principles of accounting treatment that are appropriate to an agreed set of facts.

In most instances it is not possible to separate these two elements quite as easily as this. Nevertheless, it seems to me useful, as a point of departure, to bear in mind that, regardless of the perfection of the accounting philosophy we may develop, its application will always require the accountant to exercise a high degree of opinion or judgment, if for no other reason than to answer the question, "What are the operative facts?" I may illustrate my meaning by a simple example. Let us take for granted that it is a fundamental accounting principle that, when an asset is sold for cash, the difference between its depreciated cost and its selling price is to be reported as a profit or loss. Such an accounting principle can be readily accepted. But in many areas there has not been full agreement reached as to what constitutes the proper facts to be considered in applying the principle. Suppose, for example, the sale of 100 shares of stock from a block of 1,000. In an instance where a particular stock certificate has been designated and delivered, some consider this fact as controlling in arriving at a "cost" figure, while others may seize upon the fact that each of the 1,000 shares possesses equal rights and so, considering an investment as a fungible thing, recommend the use of average cost. In case the particular investment showed more or less continual activity, some have claimed that the minimum number of shares should be, in effect, segregated and left undisturbed as a sort of "fixed" investment. For current transactions the calculation of cost would then be drawn only from purchases and sales in excess of the minimum. All these solutions are based on "facts" which are not in dispute. There is, however, a wide difference of opinion as to which of these facts should be considered as controlling.

A more difficult, but similar, problem is that of determining what force should be given to the existence of certain facts which may indicate the probability of losses resulting in liabilities to third parties. The possible treatments include (1) disclosure by a footnote reference, (2) a reservation of surplus, or (3) the recognition of an actual liability. To put it shortly, when do contingent liabilities cease to be contingent and become real? If there is a continual stream of legal claims, as, for instance, personal injuries and damage claims in the case of a railroad, there is, probably, general agreement that a specific provision is necessary since the liability may be estimated with some certainty based on past experience. But, take the case of an individual lawsuit. Mere knowledge that someone is contemplating a suit perhaps seldom requires recognition in the statements. On the other hand, is it proper to wait until the final court of appeal renders judgment before reflecting an actual liability? Such situations offer difficulty, but the difficulty does not result from doubt as to the appropriate accounting principle—that a liability should be set up when it can be expected with reasonable certainty that an obligation actually exists.

In these cases we thus have for determination the question, "What are the operative facts?" Which of two or more situations confronts us? The accounting principles are not in question. It is a problem of determining the facts that the accountant should consider as controlling. Moreover, it is a problem which is both of great significance and great difficulty in our work.

There is another aspect of this problem of ascertaining the facts of a situation that warrants some mention. In some cases it may be impossible, or impracticable, without unreasonable effort and expense, to determine just what the facts are. In such cases the question is whether it is proper to postulate certain assumptions or whether it is preferable to develop separate rules based on inadequate facts. Of course, the Commission has held repeatedly that registrants have an obligation to maintain records that will reasonably disclose the facts; yet, notwithstanding, either because of lack of prescience or the passage of time or the nature of the transaction, the amount of information available may be insufficient.

An illustration of this is the so-called "basket" transaction, in which the securities of two or more companies are purchased for a lump sum and are carried as a single item in the accounts. There may be no ready basis for making an allocation of the total cost to the various blocks of securities; yet, if one of these be disposed of, the problem is presented of determining the gain or loss, if any. The view has been offered that, since it was not possible to ascertain accurately the original cost, it would be satisfactory to credit the proceeds from the disposition to the investment account and to record no gain or loss until all of the securities have been sold, on the ground that the purchase constituted a single unit and that the transaction was not complete until the entire unit was sold. Others would permit this practice only if the reasonable worth of the unsold securities was at least equal to the remainder of the acquisition cost. Another proposed solution is to make from all available evidence some estimate of the portion of the original cost allocable to each issue, and thenceforth to use such allocations as the basis for subsequent transactions.

Is there a conflict of accounting principles here? It does not seem so to me. It is mere inability to determine all the relevant facts. If the cost had been, or now could be, allocated, there would be no question as to the proper accounting treatment. The lack of this breakdown of cost does not change the accounting principles involved, but merely makes it difficult to determine and present in the statements what has actually happened.

There are numerous similar instances where inability to secure information requires modifications in treatment that might otherwise be desirable. Thus, the detail with which, for example, plant and inventory records are kept depends upon a balancing of what might be theoretically desirable with what seems reasonable and practicable. In this large area, the judgment of the company and its accountants, or of a supervisory agency, must be depended on to decide in advance whether particular information is sufficiently material to warrant the effort required to record it.

Another facet of this problem of uncertainty is, I believe, present in the phrase, "conflicts of accounting principles." This visualizes an accounting principle which is directed toward objective A and another principle directed toward objective B. In some cases it will be impossible consistently to reach both objectives. In such a case, the argument runs, one principle must yield to the other. This is doubtless true, but it seems well to recognize that many, if not most, such conflicts are likely to arise not from irreconcilable accounting principles but rather from differences of opinion as to what are the operative facts. If the facts be X, then principle A applies; but if the facts be Y, then principle B operates. What the operative facts are, the accountant must decide. An illustration of such a conflict is found, I believe, in the case of a holding company that receives a cash dividend from a wholly-owned subsidiary and immediately reinvests such funds in capital stock of the same subsidiary. Ostensibly, the holding company has received dividend income and has made an additional investment in the subsidiary, but, if a broader view of the situation be taken, it may well be said that what has happened is essentially a declaration of a stock dividend by the subsidiary. If the facts are held to justify the cash dividend interpretation, the generally accepted accounting principle is to recognize income, but if the entire transaction is interpreted as no more than a stock dividend the generally accepted principle is, perhaps, to report no income since there has been no distribution or severance of subsidiary earnings. And those who advocate the taking up of undistributed earnings would find all of these facts irrelevant to a determination of income.

I turn now to the second source of controversy—disagreement as to principles or standards of accounting treatment. Although the development of an integrated, logical body of accounting principles has been the objective of much careful thought and discussion, there is still some disagreement as to whether such an objective is attainable, and still more as to whether, if attainable, it can be reduced to writing in such a way as to be of universal or even of general application. When the validity of specific principles is discussed, the divergence of opinion, in many areas, is at its height. Many instances familiar to all of you might be mentioned. I should like to confine myself to one issue which, though not as pervasive as some, involves most of the difficulties mentioned, and touches, in its implications, many groups of significant accounting problems.

That is the question of the treatment of premiums paid on retirement of preferred stock. In making a study of this point, we directed our attention specifically to retirements in accordance with redemption privileges of the preferred contract, and for convenience excluded cases where such retirements were part of refunding operations.

The results of this study indicated the co-existence of two principal and conflicting treatments: one, involving a charge of the entire premium to capital surplus, or paid-in surplus; and the other, involving a charge to earned surplus to the extent that such premium exceeded the paid-in surplus applicable to the retired shares. In our correspondence with practitioners and teachers of accounting we found both views strongly supported, but with no clear-cut preponderant opinion. Not only is the lack of agreement significant, but perhaps more important is the variety of reasons offered in support of each position.

Some of those favoring the charge of the premium to capital surplus argued that the retirement of preferred stock was in its entirety a "capital transaction" and that the premium should therefore be charged against such capital accounts as were available—that is, capital surplus. A related argument often expressed was that, since premiums on original issuance were credited to capital surplus, consistency required a like charging of retirement premiums. A variation of this argument was based on the ground that the contributions of stockholders of all classes (to other than stated capital) should be pooled and that, until payments in excess of stated value exceeded the aggregate capital surplus, charges for premiums paid out should go against the common pool of capital surplus. Others stated that the transaction indicated an appropriation of common capital to the elimination of a prior capital charge. Dissenters from this position contended that such a procedure would obscure the amount of paid-in capital on the residual shares, that the accounting must be made by classes, and that, consequently, the proper treatment was to charge earned surplus for the amount of the premium in excess of the paid-in surplus applicable to the retired shares, the portion of the retirement premium over and above the capital originally contributed being held to be in the nature of a special dividend or distribution of earnings to departing shareholders.

Classification of the retirement of preferred stock as a capital transaction, with the corollary that any premiums should be charged to capital surplus, is not, I think, a very helpful approach to the question. This particular argument harks back, I think, to the false syllogism of some years ago that certain types of assets were capital assets, that losses in connection with them were capital losses, and that therefore such losses were properly to be charged against capital surplus. While the cases are not similar in their underlying characteristics, both exhibit an unfortunate sleight-of-hand manipulation of terminology. It seems to me that such a discussion fails to join the issue, since it consists mostly of a series of conclusions drawn from premises largely unstated. One can admit the retirement of preferred stock to be properly defined as a "capital transaction" and at the same time can, without being inconsistent, admit the characteristics of a special dividend implicit in the retirement premium. Yet, if we are to make progress in securing general acceptance of a body of accounting principles, we must lock horns on something more substantial than conclusions based on unstated premises. To be useful the discussion must put in issue the validity of the premises as well as the logic of the conclusions drawn.

Let me illustrate the confusion that may arise when premises are unstated or terminology ambiguous. Some commentators expressed the opinion that the treatment of retirement premium would depend on whether the capital surplus arose from a revaluation of assets or from capital contributions, whereas other accountants found no difficulty here because their conception of capital surplus did not comprehend credits arising from asset revaluation.

More fundamental was the disagreement as to the available uses of capital surplus, granting it to arise originally from capital contributions. Insofar as it consisted of premiums on capital stock, some held that it should reflect by classes the premiums originally attaching to the shares now outstanding. From such a view, it follows that a retirement of a portion, or all, of any class of stock would call for a pro rata retirement of any capital surplus that may have attached to those shares through contributions of capital. This view would tie premiums received to capital stock as a second division of a single item—contributed capital.

Opposed to this is the view that capital surplus, once created, cannot be retained in separate compartments according to stock issues, but merely consists of a pool of surplus, bearing no necessary relationship to the stock issue creating it, and best analyzed in terms of the legal rules as to its distribution. Since in most states it is possible to declare a dividend from capital surplus or from the excess of assets over stated capital, adherents of this view question whether it is logically possible or significant to allocate a given dividend against any particular segment of capital surplus.

The difference between these two positions is a fundamental difference of interpretation. One holds capital surplus to be best interpreted if classified as to its source. The other holds it to be best interpreted in light of the legal or contractual relations that affect its disposition.

For my part, I feel that the separation of capital from income is an essential premise of corporate accounting, and that from this it follows that there is no logical accounting distinction between stated or par value and the additional price paid by shareholders. It is my conclusion therefore that, upon retirement of a shareholder, the excess of the amount paid him over his total contribution cannot be regarded as a proper charge against amounts contributed by other existing shareholders, at least so long as there exists a reservoir of undistributed earnings.

Discussions of the various methods of determining inventory have suffered, I believe, from the same difficulty as has the treatment of redemption premiums on preferred stock—a failure to stipulate the objectives of the accounting practice and a failure to posit criteria, the existence of which would indicate attainment of those objectives. Indeed, there is often a failure to state the criteria that are in dispute.

Support of cost as opposed to market, or cost or market, as well as support for first-in, first-out as opposed to average, or last-in, first-out has often been based on such arguments as: "It tends to give a conservative statement for the balance sheet;" or "It tends to reflect actual income;" or "It observes the principle of not anticipating profits and of recognizing and providing for reasonably expected losses." Such statements are as faulty as the statement that doping a race horse is desirable "because it makes him run faster." We see the fault of this statement because we have set the objective of the race; namely, a contest pitting the natural ability of one horse and rider against the natural ability of another horse and rider. It is not intended to be a contest interested solely in the speed of the horse, regardless of how achieved, nor is it intended to be a contest between rival stimulants to see which produces the more startling results. Nor can we refute the statement with the sophism that we want a "fair" race. What is fair or unfair depends on the objectives or criteria which we feel govern the situation. If our desire is to see the maximum speed that a horse can deliver with all external assistance, then any stimulant is doubtless "fair."

In the case of inventories, two principal approaches have been taken—one, starting with the balance sheet; the other, with the income statement. Of course, if it be proper to assume that the two statements are fully complementary, faithful determination of the amount to be shown in either statement would necessarily determine the other.

The reasoning of those who seem chiefly concerned with balance sheet presentation has generally taken the following course (disregarding the various methods of determining cost):

1. What has been spent for goods to be resold?
2. How much of this "cost" may properly be retained on the statements as applicable to subsequent accounting periods?

And the test has been, ordinarily, whether the expected selling price (not in forced liquidation) will be such as to cover the stated amount plus future selling expense, plus presumably a fair share of general expenses, and possibly a "normal" profit.

Those who emphasize the determination of income frequently rest their case on the statement: "This, or that, method is best because it prevents the arbitrary shifting of income from one period to another." However, in a disagreement as to the amount of "cost" that should be charged against income, each side quite honestly feels that it is his opponent's method which arbitrarily shifts income. And without objective criteria, the discussion quickly reaches an impasse.

While the balance sheet approach may at first appear somewhat more objective, in practice defense of a particular amount is most frequently made on the ground that "It is conservative"—conservative always meaning "lower." But if conservatism is the test, is not a zero figure its most faithful application? If not, why is "market" the most desirable criterion of the right amount of conservatism?

Even here, we do not reach the end of the inventory problem. The very determination of "cost" is by no means a settled issue. Dispute as to the relative merits of last-in, first-out, average, and first-in, first-out as methods of arriving at "cost" has provoked literally dozens of articles in the past several years.

At times the discussion turns to questions of "physical flow," "conformity to actual facts of operation," "actual costs," and the like. Yet, accounting in many respects seeks to divorce the process of "accounting for" or "matching" from fortuitous physical events. The date of purchase of a building, or payment of an insurance policy or of wages is not considered determinative of the date of allocation against income—the practices actively followed in all of these instances are obvious judgments that these physical events are an inconclusive basis for a rational accounting process. At least it may be said that accounting selects and rejects in the world of physical events—with the objective of determining what physical events are operative—within the framework of its logic. The argument as to physical flow stops where it starts with the statement, "This method is in accord with the physical facts." Indeed, it is not infrequently true that each side can find, in a factual description of the course of production, facts which persuade them that their method of determining inventory amounts is truly in accord with physical conditions.

In the special field of basic fungible commodities, an inventory method frequently used seeks to remove from the income statement and permanently from the balance sheet all changes in prices with respect to the major portion of the inventory—principally, it would seem, on the ground that such fluctuations are common to the industry, inevitable, unavoidable and therefore not to be shown. Their opponents, with fine irony, merely point out that this improperly levels out the reported income stream, misstates the balance sheet, and is therefore quite obviously bad. One is reminded of the question posed for a squad of debaters: "Resolved, that it is hotter in the city than it is in the summertime." There can be no ground for argument until some agreement is reached on the basic premises on each side that are in conflict. Here, as in the preceding instances we have discussed, there is a deep and vital conflict in each party's conception of objectives and of the criteria that should be used in judging the propriety of accounting principles applicable to inventory. As is often the case, however, criticism is far simpler and safer than the proffer of a solution—which, fortunately, is not within the scope of this paper.

I have sought to illustrate by these examples what I feel are the principal reasons for controversies which arise in considering the propriety of a particular set of financial statements. First, there are differences of opinion as to the facts, and second, disagreements as to the accounting treatment to be accorded a particular set of facts. The mere existence of these two sources of conflict is not the important thing to recognize. Rather, it is the notion, "What can be done about it?" As regards the responsibility for carefully ascertaining and intelligently sifting the facts of a given situation, we can insist upon maintenance of high standards of training and integrity as prerequisites to entrance to the profession of accountancy. We can further insist that those who consider themselves to be expert accountants must have and exercise that high degree of care, skill and acumen which is commensurate with their calling.

In determining the accounting principles applicable to given situations, there is a good deal we can "do about it." We can determine the areas in which our conflicts exist, and then attempt to pursue the cause of our conflict far enough to perceive the underlying difference in the criteria or standards that each person considers as controlling. Too often, each side presents its own cogent reasons and then rests on the conviction that its position has not been disproved. But in many instances it might be added that there is equally a failure to disprove the position of the opponents. This may have the advantage of stimulating one's faith in one's own convictions but it does little to promote solution of the controversy. To resolve fundamental disagreements on accounting principles we must find out wherein our disagreement lies and make that the arena.

Such searching analysis will not bring us to a set of principles that will permit us to solve all accounting problems with mathematical precision. There will not always be complete agreement on the facts of a situation nor on the operation of those facts, and so accounting treatments cannot be completely predictable. However, it seems to me that, if accounting is to realize its greatest usefulness, it should be grounded on rules or standards of general applicability. There are many that feel this is impossible. They view accounting as something essentially pragmatic which cannot be predominantly deductive. It is felt that insistence on certain rules or principles would straight-jacket accounting and, as one writer puts it, "be reminiscent of the famous bed of Procrustes who stretched out his guests or chopped them off if they did not fit the furniture."

Such a view seems to me, however, to offer little hope of a full development of the services of accounting. Accounting is a form of language used to communicate financial ideas between individuals. Language, however, is a very imperfect means of communication, and if we are to avoid confusion we must be sure that the recipient of our ideas can understand what we say. He cannot understand if we lack any agreement as to guiding rules of accounting and, consequently, report identical situations in a variety of ways. To be sure, we cannot show everything in our statements, and therefore we should agree, it seems to me, on what they should show and rely on collateral notation or supplementary schedules to furnish additional pertinent, and generally highly important, information.

DISCUSSION

CHAIRMAN PARK: We are now open for discussion from the floor. Are there any questions?

VICTOR H. STEMPF (National President, N.A.C.A.): I hesitate to take the floor, because I would rather offer a motion shelving the rest of the program in order to devote the rest of the time to a discussion of these two excellent papers.

As is usual, Mr. Werntz has presented an admirable coverage of his subject, with which I find myself in thorough agreement with three exceptions. My first point of difference concerns the principle involved in retirement of stock. I think there are two conflicting theories. One school believes that, to some degree, we should inject the principles of partnership accounting into our corporate accounting. According to this school, it is possible to allocate individual stockholder's rights and reflect them in the accounting statements. The other school maintains that all corporate accounts become a pool, and ignore the individual stockholders. I think any attempt to invoke the partnership philosophy results in chaos. Then we come to the "corporate-entity theory," where individual stockholders cannot be considered; it is, obviously, a practical impossibility. I believe that, on this matter of retirement, stock premiums should be charged wholly to capital surplus. And there I disagree with Mr. Chamberlain, also.

On the second score, I am one who adheres to the maxim that we should provide for maximum possible losses and anticipate no profits, an axiom which Mr. Werntz seems to question. The ultimate individuals to be considered in corporate accounting are the managers and stockholders. They are more interested in the trend of the business and what it is going to do over a period of years than in the immediate year. We should not anticipate earnings until transactions are consummated. The best we can do from year to year is to determine within reason, and with application of our best measuring stick, a reasonable estimate of the earnings for a year, but keep a weather eye on the long-range results.

My third objection is to Mr. Werntz's statement that Mr. Chamberlain is a difficult man to follow. I usually find Mr. Chamberlain easy to follow, because I can always find something upon which to disagree with him. Certainly, so far as the principles he has enunciated are concerned, we will accept the resumé of the American Accounting Association's tentative statement as broad basic truths. Where we get into difficulty is not in these basic truths but in the application of these principles. And in the friendliest of spirit, I accuse Mr. Chamberlain of drafting a document which presents "Ideals of perfection."

In his opening remarks, Mr. Chamberlain referred to published financial statements, demonstrating the absence of accounting principles. I think these examples are the exceptions, and not the rule. Certainly, we recognize cost as a fundamental concept in our balance-sheet accounting. But when you talk of 'fair market value,' what do you mean? Fair market value to whom? Do you mean to the seller or to the purchaser? Which is it? In capital assets, is it prehistoric cost? Or is it utilization value to the purchaser? It is easy to see that it is the *application* of the principles that gets us into trouble.

Passing to the income principle, matching costs against revenue is fundamental, and I think we agree that the consolidation of earnings over a period of years should present a complete picture, requiring no consideration of surplus adjustments. But there again we have two schools of thought. One school thinks everything should go through the income statement; the other school justifies surplus adjustments on the ground that surplus is the cistern into which buckets of income are poured. If we could get the profession as a whole to do one thing or the other (it wouldn't make a lot of difference which), everything would be rosy, but I think we will continue to have these opposing schools of thought for years to come. In the end, we may have a compromise. We may show a combined statement of income and surplus for the year, and thus eliminate most of this disagreement.

As to the basic capital principle, I think we can agree; but I, personally, disagree on the related point concerning premiums on the retirement of stock. I think that here again the partnership concept has been injected into corporate accounting.

The further recommendation is made that reacquired shares of capital stock be shown as a deduction from capital stock and surplus, and an indication given of the earmarking of surplus; but I disagree. I am against a further earmarking of surplus in this particular form of presentation because I think that the very form of presentation makes it unnecessary. We have two theories. One is the constructive retirement theory, based on the erroneous conclusion that, sooner or later, the stock will be retired. Opposed to it is the trust-fund theory, which considers that issued stock is a trust fund, and cannot be impaired without formal legal reduction of such issued stock.

The S.E.C., at first, said that reacquired shares of capital stock could be shown (1) as an asset, (2) deducted from capital stock, or (3) surplus, or (4) from the sum of capital stock and surplus. When these rules were amended, it was recognized that it should not be considered as an asset.

When deducted from capital stock, it indicates that the stock is going to be retired. When reacquired shares are deducted from surplus, it is indicated that the stock is to be retained as treasury stock. When it is deducted from the sum of the two, it properly leaves the ultimate disposition in suspension. The indication is that, at the date of the statement, the corporation does not know what will be done with the shares; and I prefer that treatment. As that form of presentation indicates that there is a relationship between these reacquired shares and the surplus and capital stock, I think this presentation avoids the necessity for further earmarking.

I would like to carry on much longer, but I realize that there are others present who have views to present. I pay tribute to the Executive Committee of the American Accounting Association; I think it has come to recognize more clearly the difference between principles and applications. I think we are definitely making headway there. In answer to Mr. Werntz's question, I think the determination of basic accounting principles will be a slow job, and will require the viewpoint of academic men, of those in public practice, and of accountants in industrial work. Then, in the cauldron in which these views are boiled, I think we shall reach sound, applicable conclusions. But let us not be impatient. It will be a slow evolutionary process, not revolutionary.

MR. CHAMBERLAIN: I should like to comment on a couple of points raised by Mr. Stempf. I believe Mr. Stempf said the executive committee of the American Accounting Association took exceptional or unusual cases as the basis for its statement of accounting principles. A little later he said, in effect, that the principles suggested by the Association were principles of accounting that have been and are now accepted. I am happy to learn that Mr. Stempf accepts these principles.

Another point raised by Mr. Stempf has to do with that old controversy—charges to profit and loss versus charges to surplus. I think it a great mistake to talk about extraneous or non-recurring charges and credits as though those charges and credits were most unusual in the life of business. I suppose everyone has had the experience of trying, without much success, to budget his personal finances. The things that throw the budget out of balance are the "non-recurring" charges that are constantly recurring. We don't anticipate unusual medical expense or automobile accidents or similar things, but we usually have these so-called nonrecurring charges in one form or another, and in greater or lesser degree.

Business, like our personal affairs, does not go along on an even keel. We suddenly encounter unforseen obsolescence; we incur so-called capital losses; tax assessments relating to the income of prior years fall upon us or an obsolete bond issue must be refinanced. Why try to create an illusion of smoothness when actually the road is quite rough?

I gathered that Mr. Stempf was in substantial agreement with the capital principle. He expressed the view that deducting the cost of treasury shares from the sum of capital and surplus is a sufficient disclosure of a restriction on earned surplus. My feeling is that this treatment is not a sufficient disclosure, and that the added statement of the restriction can be only helpful to the reader of the statement.

MR. STEMPF: I refrain from saying more.

MR. WERNTZ: Victor Stempf is a very excellent commentator. He is better only when he makes a six no-trump doubled and redoubled vulnerable contract. However, at this time I should like to take issue with him on two counts.

The first is the partnership item. It seems to me that by the very introduction of classes of stock—say preferred and common—you thereby introduce the necessity for distinction between them. But so long as we have introduced various types of shares and the resultant difficulty of classifying owners, we cannot ignore the fact on the balance sheet. Everyone now agrees, I think, that the capital contributed by common and preferred stockholders should not be amalgamated. I think the same logic refutes the idea that capital surplus need not be analyzed but instead may be considered as a common pool. My other point on that same issue is the common stockholder who is left. Suppose there is just the common stock. Everyone pays in par and a 10-point premium. If one of those shares is then repurchased at over 110, the remaining stockholders have a right to know about it. Nor does that repurchase in any way alter the amount which the remaining shareholders contributed.

I also wish to point out that I am very sceptical of any reliance placed on the trust-fund theory in this connection. In the first place, it applies, I believe, only between creditors and stockholders. In the second place, most modern corporation laws have gone rather far away from it.

MR. STEMPF: I should only like to say that, due to the fact that we try to classify the asset side of the balance sheet, there is no reason to classify each separate dollar as on deposit in a certain bank. But that's where all this earmarking is going to lead to.

STEPHEN GILMAN (International Accountants Society, Chicago, Illinois): For some years I have been greatly interested in the various discussions of accounting principles and in various attempts which have been made to formulate them. It occurs to me that there is one factor seldom recognized or discussed which makes this task a peculiarly difficult one. I refer to the relation of expediency to practical accounting situations. Perhaps the word "expediency" is not well chosen, although it should be understood that I am not using it in any unpleasant sense. It is but normal and human for the practitioner to have a feeling of real sympathy for the problems of his client or for the industrial accountant to have a similar feeling of sympathy for the problems of his employer. Expediency, while important in tackling practical accounting problems, does not offer a correct approach to the formulation of accounting principles. That is one of the reasons why I have been so greatly interested in the work done by the American Accounting Association, the members of which approach the task of formulating accounting principles from a somewhat detached viewpoint. More colloquially, these men, many of them engaged in educational work, may be said to have no ax to grind.

The fact that the subject of accounting principles is being discussed so often and so thoroughly in meetings of this kind, and is receiving ample attention in the pages of such technical periodicals as the *Journal of Accountancy*, *The Accounting Review*, and the publications of the National Association of Cost Accountants is most encouraging and confirms the general belief that the profession is making real progress in formulating a body of accounting principles which may at least represent a point of departure for some of the necessary expedients of actual practice.

SECOND SESSION

FRIDAY, MAY 16, 1941 — 1:00 P. M.
Faculty Club (Luncheon Session)

Brief Entertainment

THIRD SESSION

FRIDAY, MAY 16, 1941 — 2:30 P. M.

Commerce Auditorium

Chairman:

VICTOR H. STEMPF, *C.P.A., Touche, Niven & Co., New York; President, The National Association of Cost Accountants*

Subject: "Accounting Problems in the National Defense Program"

(a) Cost Problems

(b) Tax Problems

Papers:

ERIC A. CAMMAN, *C.P.A., Peat, Marwick, Mitchell & Co., New York; Past President, The National Association of Cost Accountants*

J. A. PHILLIPS, *C.P.A., J. A. Phillips Company, Houston, Texas; Member, Committee on Federal Taxation, The American Institute of Accountants*

INTRODUCTORY REMARKS

By Victor H. Stempf, *C.P.A.*
Touche, Niven & Co., New York;
President, The National Association of Cost Accountants

Some twenty years ago a fair-haired, rosy-cheeked boy began setting the important standards of our modern concepts of costs. In the years that have ensued, he has continued to make a niche for himself in the hall of fame of accountancy that is destined to be important for generations. A member of the Society of Certified Public Accountants of New York and New Jersey, he is past National President of the N.A.C.A. and a member of the American Management Association. In 1932 he made his major contribution to the literature of accountancy in his *Basic Standard Costs.*

The remarkable thing is that, today, he is still a fair-haired, rosy-cheeked boy. He has an almost superhuman capacity for intensive work and intensive play which has endeared him to his associates. It gives me great pleasure to present to you Eric A. Camman, who is at present serving his nation in Washington with O.P.M. Mr. Camman.

ACCOUNTING PROBLEMS IN THE NATIONAL DEFENSE PROGRAM

By Eric A. Camman, *C.P.A.*
Partner, Peat, Marwick, Mitchell and Company, New York, N. Y.; Past President, The National Association of Cost Accountants

THE NATIONAL DEFENSE PROGRAM

Size and Scope of the Defense Program

It is desirable in approaching consideration of the accounting problems which arise under our national defense program to pause for a moment at the outset to regard the undertaking which is planned on such a vast and unprecedented scale. Undoubtedly, we shall all obtain a very much better understanding of the enormity of the task we have to accomplish as time goes on. Everyone knows that the country has adopted a vigorous schedule for preparedness and for rearmament, and that the various departments and agencies of the Government in Washington have been busily engaged in the placing of contracts for the production of guns, munitions, airplanes, ships, machinery and numerous items of equipment and supplies required. The magniture and complexity of this program are difficult for the ordinary person to realize, and are inclined to be underestimated even by those who have had close contact with its actual manifestations in Washington or in manufacturing plants throughout our land. The comparatively short span of time in which things have been done and in which progress has been made has something to do with the lack of general appreciation of the tremendous job which remains to be done.

I think it is a fair statement, however, that, notwithstanding a rather vague public concept of the nature of some of the production problems to be faced, there no longer remains in the minds of most Americans any doubt about the need of urgency for adequate means of defense for our nation and of aid for our friends overseas. Events abroad have moved so rapidly that speed and yet more speed is vital. A time schedule which six months ago appeared reasonable, today has become too long and too liberal and must be bettered.

Great things have been accomplished, and records are being made and broken that may be read in the history of our development when the time comes for review. Just now there is not time to stop and read. For example, the machine tool industry in the years from 1935 to 1939 averaged approximately $100 million of sales annually; in 1939, they turned out $200 million; in 1940, they turned out over $400 million; and in 1941, the total output will be in the neighborhood of $700 million.

A year ago, we were producing some 200 large engines a month for our aircraft. Today we are turning out approximately 2,500 a month, a twelvefold production achieved in the space of a year. Each of the new airplane-engine plants—Ford, Studebaker, Packard, Buick—will cost from $30 million to $40 million apiece, and will be in production within a year after they were started. Huge tanks, representing entirely new production for us, will begin coming off the assembly lines in substantial quantities soon. You have all read in the recent news about the first tanks produced at the plants of the American Locomotive Company, and Baldwin Locomotive Works, and the Chrysler plant. It is interesting, in referring to these tanks, to mention that a medium-sized one weighs about thirty tons, and the transmission alone in one of these tanks weighs 7,600 pounds.

In all other directions rapid progress is being made. Machine guns, anti-aircraft guns, ammunition production, and ship construction are coming along in what would be excellent performance under normal conditions. A recital of such facts has the tendency to make one feel satisfied that we are doing well and getting somewhere. I should like to leave with you a word of caution against such self-satisfaction. We have not time to be complacent about it, and must do still better and obtain still more impressive results.

You may obtain some idea of this when I mention that it has been estimated that Germany started the war with a military machine which could be matched by us only by an expenditure of about $100 billion. It has also been estimated that when she attacked Poland in September, 1939, Germany was spending approximately $1 billion per month for war, and that that rate of expenditure has been increased so that it is now probably well in excess of $20 billion per year. The United States, claiming the greatest industrial facilities in the world, spent in the last 6 months of 1940 less than $2 billion, and will have spent, in the fiscal year ending next June 30, no more than $6 billion. Our defense program calls for the expenditure of more than $40 billion in the years 1941 and 1942. Contracts have been awarded toward this goal of something over $15½ billion, but the Treasury has paid out, to date, less than $5 billion. These figures indicate the urgent need for greater speed, and it seems to me important that every business man and every accountant—indeed, and every citizen—should be made aware of it.

Defense Organization

All of you are undoubtedly familiar with the name "Office of Production Management" (OPM), but probably many of you have obtained only a general idea of the functioning of this agency and its affiliate agencies in the defense effort. The Office of Production Management is concerned in aiding the various branches of the Government, notably the War and the Navy departments, in the procurement of all of the many things that they need and in expediting and facilitating their production.

The Office of Production Management is divided into 3 subdivisions. One is the Division of Purchases, whose main function it is to see that the goods we buy for our Army and Navy, and under our Lend-Lease program, are bought as wisely and economically as is possible and with due regard for the least dislocations to our industries and to our civilian population.

Another is the Division of Production, which deals with the many problems which arise in finding plants with facilities for producing the needed things, and in helping manufacturers with their own problems of organization or procurement and supply.

The third is the Priorities Division, much in the news at the moment, which is charged with the duty of organizing and coordinating the available supply of raw materials. The demands of the defense program are so extraordinary, for the production of munitions, tanks, airplanes, guns and all the myriad other articles, that a critical situation as to supply arises with respect to some materials and will continue to arise with respect to others. Obviously, if the supply of an important material becomes limited, someone must decide how this limited quantity is to be apportioned to achieve to the greatest extent the aims of the defense program, and that is essentially the function of the Priorities Division.

Another of the important problems to be met is how to prevent or check the natural tendency of the present extraordinary demands from sending prices spiralling upward. To meet this problem there was established recently, by executive order, the Office of Price Administration and Civilian Supply. It is the function of this office to watch the trends of prices and to take proper measures to stop dangerous price increases before they get out of hand.

There are other agencies, whose operations are not especially significant to our topic today, which have important functions, such as the National Defense Mediation Board, the Coordinator of Defense Housing, and the Division of State and Local Cooperation.

In addition to these various divisions, there is the Office for Emergency Management, recently established by executive order, which serves as a managerial and coordinating agency over all the others.

ACCOUNTING PROBLEMS OF THE GOVERNMENT AGENCIES

Escalator Clauses

In order to afford a measure of protection to the contractor against rising costs of wages and materials, and, conversely, to protect the Government against prices which are too high through excessive provision for contingencies, clauses of one or another type have been used in Government contracts called Escalator Clauses. Time will not permit entering into a description of the various types, and it will suffice to say that efforts are being made to correct certain defects in them, which have become apparent, by a new form of Escalator Clause, which has been proposed by OPM for use when such clauses are desired in fixed-price supply contracts. The problem consisted in working out a scheme that would cover the manufacturer for increased costs, up to but not to exceed his own actual costs, and to protect the Government by limiting any such increases to those shown by a suitable indices of general increases obtained from the Bureau of Labor Statistics as to wages and wholesale prices of materials.

In other words, the Government under the proposed clause would undertake to reimburse the contractor for wage-rate increases in the ratio shown by the BLS index or by the manufacturer's own cost index, which ever is the lower. Similar provisions are made along the same general lines with respect to the principal materials.

Provision is also made to protect the Government in the case of decreases. An example is given in illustration "A" of the working of this proposed formula with respect to labor.

Cost Plus Fixed-Fee Contracts

Certain contracts with the Government are entered into on the basis of paying the contractor his actual cost plus a fixed fee stipulated in advance. Such contracts provide for the keeping of separate records of the pertinent costs and for the inspection and audit of such records. Obviously, some definition of cost is required in order to set a standard, for the purpose of the contract, as to what items may be included and what items may not be included as costs. One of the questions that is now up for consideration is whether better and simpler definitions than those heretofore followed can be laid down. No proposals have as yet been formulated.

Amortization of Emergency Facilities

One of the most perplexing problems which has come up relates to contracts under which rapid amortization of emergency plant facilities is permitted under the Internal Revenue Code as amended in 1940 (Section 124). Much confusion has existed about this problem, and I should like to dwell upon it a moment in an endeavor to dispel some of this confusion. You will recall that last Fall there was much comment in the public press about the reluctance of industry to invest private capital in new or extended plants and facilities without some reassurance as to the tax policy. You will also recall that to induce the investment of private capital the President issued a statement that suitable changes would be made in the tax laws to permit amortization of such facilities over a five-year period, and you will remember that the Internal Revenue Code was amended toward that end by Section 124. The gist of the amendment is that a corporation which has spent money for the building of additional plants or facilities for the production of defense materials may, for tax purposes, write off the cost thereof over a period of five years. This arrangement frankly offered to private capital a bargain to put up the needed extra plants and get the benefit of full deduction of the cost of it during the high tax years immediately ahead, and thus to have it at the end of the period, for such use as it might then be, at some fraction of its original cost.

The wording of Section 124, however, in paragraph (i) is such that certain steps are required to establish the right to this tax amortization. This section, omitting some words for the moment for the sake of clarity, reads as follows:

> If the taxpayer has been or will be reimbursed by the United States for all or a part of the cost of any emergency facility pursuant to any contract with the United States, ... no amortization deduction with respect to such emergency facility shall be allowed . . . . unless . . . . the Advisory Commission to the Council of National Defense, and either the Secretary of War or the Secretary of the Navy certify . . . . that such contract adequately protects the United States with reference to the future use and disposition of such emergency facility.

Thus far the quotation seems clear enough. It holds that if the contractor wishes to take advantage of the tax amortization deduction, while the Government is reimbursing him for all or a part of the cost of his investment, the Government's interest in the property through such reimbursement must be properly protected. This requires the Certificate of Government Protection.

Now, when the contractor is not being reimbursed for any of the cost of the emergency facilities which he provided and for which he wishes to take the tax amortization deduction, there is further provision in this section that a Certificate of Non-reimbursement may be issued. The wording is as follows:

> A certificate by the Advisory Commission to the Council of National Defense and either the Secretary of War or the Secretary of the Navy, made . . . . to the effect that, under such contract, reimbursement for all or a part of the cost of any emergency facility is not provided for . . . . shall be conclusive for the purposes of this subsection.

This provision taken by itself seems clear enough, but a difficulty is encountered in determining non-reimbursement, because most supply contracts are silent upon the point, and in an earlier clause of the same section it is held that there must be no indirect reimbursement in the prices of supply contracts, namely: "Because the price paid by the United States (insofar as return of cost of the facility is used as a factor in the fixing of such price) is recognized by the contract as including a return of cost greater than the normal exhaustion, wear and tear." The problem is to ascertain through sufficient tests or evidence that the contract price does not include anything more by return of cost of plant than normal exhaustion, wear and tear. This problem is a very real one and it has resulted in delay in the issuance of Certificates of Non-reimbursement. Procedure is now being worked out for dealing with this problem and for expediting the solution.

Naturally, the contractors who have applied for Certificates of Non-reimbursement and who have not thus far received them are concerned about it, and there have been considerable confusion and charges of bad faith and delay of the whole defense program, and occasionally articles of comment in this vein have appeared in the press. It should be clearly understood that there is no bad faith involved and there has been no delay whatever in the defense program, because the production of supplies under these contracts has been going forward. The truth of the matter is that this problem arises mainly from the peculiar wording of Section 124 (i), which can not be ignored. As stated, measures are now being taken to solve the problem, and in the meantime there is no reason why defense production should be hampered, nor is the contractor being deprived of any of his rights.

Other Accounting Problems

Of course there will be other accounting problems to be met from time to time in the Government agencies in dealing with contracts under the defense program. The more important ones now known are those which have been touched upon. There are others of considerable complexity discernible in the immediate future due to the pressure of rapidly changing events, but they are not sufficiently crystallized to warrant mention at this time.

ACCOUNTING PROBLEMS OF THE INDIVIDUAL CORPORATION

The peculiar requirements of production under Government contracts of one kind or another for defense projects naturally will bring along new problems and new measures of accounting treatment, as well as extensions in existing accounts and records which should be set up as a matter of abundant caution and good management. The problems which arise are likely to be individual ones, and the measures to be adopted of course must be such as to fit the specific case. However, certain items for consideration might be set down as of general application, somewhat as a check-list of things to think about.

Plant and Equipment Records on Emergency Facilities

It is safe to reason that, whenever emergency plant facilities for use in the production of defense materials are involved, a separate record should be established, fully identifying all such plant and equipment under each Certificate of Necessity. A warning note is given in connection with the application for a Certificate of Necessity, in the following terms:

> Attach, as Appendix A, a detailed list of the facilities. (Note: Appendix A as prepared by the applicant will be attached to the certificate issued. Responsibility for errors and vagueness of description, therefore, rests with the applicant. Description should include (i) for buildings, data as to location enclosing map or blue print if possible, type, character, location and dimensions; (ii) for tools or machinery, plant or order numbers if available, or other descriptive information).

It seems almost trite to point to the wisdom of providing at the outset for having adequately itemized and detailed plant records for extended plant facilities, but apparently someone connected with the drafting of the application for the Certificate of Necessity felt it incumbent to emphasize this feature, and it would be remiss to overlook it.

Escalator Clauses

Where escalator clauses exist in government contracts, special accounting provisions will be needed to set out clearly the contractor's actual costs for labor and for the materials concerned. As to labor, data probably would normally be present concerning man hours and man earnings, but provisions may be required for segregating overtime and special premiums. As to materials, possibly separate material-control accounts would be advisable, by means of which there could be developed the ratio and the extent of increased costs. Special provisions may have to be made to furnish the figures on a calendar-month basis.

Costs With Respect to Each Contract

It will probably be found a wise precaution, in the cases of contractors who have several or numerous contracts with the Government for supplies, to keep separate records of the costs applicable to each contract. The information will prove useful in case any question arises and it should also prove valuable for the purpose of estimating and quoting upon future contracts. Separate records are usually required under cost-plus-a-fixed-fee contracts.

Amortization vs. Depreciation

In any case in which the tax amortization deduction is taken it might be well to make the entries so as to keep clear and distinct the amount which would represent the normal depreciation deductible under Section 23 (i) of the Internal Revenue Code and the additional amount which represents accelerated depreciation taken under Section 124. If obsolescence enters into the former, it might also be useful to know the amount of it. Certain difficulties can be envisioned if the amount of depreciation under Section 23 (i) differs from the rate of depreciation included in normal overhead rates for manufacturing cost purposes, but we can not here generalize upon them.

A matter of importance to be observed by the contractor, in connection with this subject of depreciation, is that care must be taken, in compiling cost estimates for the purpose of quoting upon supply contracts, to see to it that no depreciation whatever is included on supplies manufactured in a plant constructed under an Emergency Plant Facilities contract (as is especially provided in the text of such contracts), and that the amount included in price for supplies, where a Certificate of Necessity has been obtained, is not greater than normal exhaustion, wear and tear.

CONCLUSION

We have come to appreciate the importance of industrial accounting as a function of effective management under ordinary conditions of operation in our competitive system. It seems reasonable to conclude that industrial accounting will become of even greater importance under the trying conditions before us, with ever-expanding demands upon production facilities, with the urgent stress for speed and yet more speed in output, and with all the other unusual difficulties attendant upon our defense program. All of the problems which lie immediately ahead can not be

Illustration "A"

EXAMPLE ILLUSTRATING PRINCIPLE OF PROPOSED ESCALATOR CLAUSE

Adjustment for Cost of Direct Labor[1]

Quota Period	*B.L.S. Average of hourly earnings* (2)	*Actual Cost of Direct Labor*		*Ratio of Change in wage rates paid Contractor's Direct Labor (Expressed in % of wage rates paid on base date)*		*Adjusted Cost of Direct Labor*	*Labor Cost Quotas (of Estimated Direct Labor Cost)*		*Applied Percentage of Change*		*Addition to Total Payment*
I	103	$39,200	÷	98	=	$40,000	$36,000	×	0	=	$ 0
II	105	31,200	÷	104	=	30,000	27,000	×	4%	=	1,080
III	107	33,600	÷	112	=	30,000	27,000	×	7%	=	1,890
		$104,000									
		—90,000 (Estimated Cost)				$ 100,000	$90,000				$2,970(1)
		$14,000 (3)									

(1) Adjustment for indirect labor is given to the extent of an agreed percentage of the adjustment for direct labor.

(2) For the sake of simplicity, B.L.S. average of hourly earnings for base month is assumed to be 100.

(3) Additions to total payment not to exceed this amount for direct labor.

foreseen, but assuredly there will be a still greater need than in the past for adequate means of control over operating costs under impulses which will always tend toward increased costs; still greater need for reliable means of cost estimating, and cost research into the possibilities for the use of substitute materials; and, in the far view, serious need for means of meeting the many problems of adjustment and readjustment that we shall have to face.

CHAIRMAN STEMPF: Thank you, Mr. Camman, for your excellent summarization of the cost problems involved in the national defense program. In passing, I have to remark that when Mr. Camman speaks of "simplicity" I break out in a rash of inferiority, because the things that are simple to Mr. Camman are rather abstract and complex to me. Practically speaking, of course, you can't deal with a complex subject in simple terms.

I count it a misfortune that I cannot talk of the next speaker as intimately as I can of Mr. Camman. I have not had the privilege of knowing him until the last two or three years. He is a faithful, native son of the Lone Star State. For twenty years he has been a C.P.A. of Texas and Louisiana, a past president of the Texas Society of C.P.A.'s, and he is also past president of the State Board of Accountancy of that state. He is an active member of the American Institute of Accountants, and a member of its Committee on Federal Taxation. I give you Mr. J. A. Phillips.

TAX PROBLEMS IN THE NATIONAL DEFENSE PROGRAM

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REVENUE ACT OF 1940

The introduction, in the House of Representatives, on May 30, 1940, of H.R. 9966 marked the first step toward accomplishment of the program of taxation to help pay currently the cost of National defense. The original bill provided for a 10 per centum increase in taxes, to remain in effect for a 5-year period. Subsequently, the Ways and Means Committee broadened the scope of the bill to provide for permanent increases of income taxes, and to provide for 10 per centum super-tax increase for a 5-year period, applicable to taxable years beginning after December 31, 1939. The bill was agreed upon in Conference on June 21, 1940, and it became the Revenue Act of 1940, when it was signed by the President on June 25th. Primarily, it dealt with income tax, though other tax increases took effect on the following dates:

June 26, 1940—increase in withholding rates;
June 26, 1940—increases in estate and gift taxes;
July 1, 1940—increases in excise, miscellaneous, stamp, tobacco, and liquor taxes, and reduction in the admission-tax exemption;
The capital-stock-tax new rate was made effective in the reports filed on or before July 31, 1940.

Taxes for defense, as provided for in the Revenue Act of 1940, present no new problems—except the problem of how to obtain funds to make the increased payments.

The changes in the witholding rates merely substituted 15 per centum wherever 10 per centum occurred in Section 143 of the Internal Revenue Code; amended Section 144 to provide that the withholding rate in respect of dividends should be 15 per centum instead of 10 per centum; and added subsection (h) to Section 143, to give effect in that section, and in Section 144, to the 10 per centum defense provision, for the period after June 25, 1940, and before January 1, 1945.

Estate and gift taxes were increased 10 per centum. That is to say, the amount of tax payable under the 1940 Act shall be 10 per centum greater than the amount of tax which would be payable if computed without regard to the 1940 Act. The increase applies to estate taxes for a period of 5 years from June 25, 1940, and applies to gift taxes for the period from June 25, 1940, to December 31, 1940, and for each of the calendar years 1941 to 1945, inclusive. (Gift tax for 1940 subject to correcting adjustment.)

Capital-stock tax was increased 10 per centum, and the increase applies to the year ended June 30, 1940, and to the four succeeding years ending June 30.

The Revenue Act of 1940 did not change the rate of the normal income tax payable by individuals (except for the 10 per centum for defense), but it substantially increased surtax rates, payable by individuals. The 10 per centum defense tax applies to all income-tax returns for the 5-year period, 1940 through 1944 (or for any taxable year beginning after December 31, 1939, and before January 1, 1945). The amount of the defense tax shall be 10 per centum greater than the amount of tax computed without regard to Section 15 (the defense tax section), except, in no case shall the effect of Section 15 be to increase the tax, computed without regard to such section, by more than 10 per centum of the amount by which the net income exceeds such tax.

The 1940 Act increased the rates of tax payable by corporations by 1 per centum of normal-tax net income, and, as in the case of individuals, provided the 10 per centum defense tax in an amount equal to 10 per centum of the normal tax.

Other changes effected by the Revenue Act of 1940 that seem to be worthy of mention are:

(1) The personal exemption, in the case of one having single status, was reduced from \$1,000 to \$800, and in the case of the head of a family or one having married status the exemption was reduced from \$2,500 to \$2,000.

(2) The requirement for filing returns. The amount of the personal exemption fixes the measure of gross income permitted without requirement of return. If gross income equals or exceeds the personal exemption, a return must be filed, though a taxpayer may sustain a net loss.

SECOND REVENUE ACT OF 1940

On August 27, 1940, there was introduced in the House of Representatives H.R. 10413, providing for excess profits taxation and special amortization. The bill was agreed upon in conference, on September 30, 1940, and was passed by the House and Senate on October 1, 1940. It became the Second Revenue Act of 1940, when it was signed by the President on October 8th. The principal features of the Act are:

(1) An increase of 3.1 per centum in the rate of normal income tax on corporations with normal tax net incomes of more than $25,000, for taxable years beginning after December 31, 1939;
(2) Amortization, over a period of 5 years, of the cost of emergency facilities;
(3) Suspension of the profit-limiting provisions of the Vinson Act and certain provisions of the Merchant Marine Act, 1936;
(4) Taxation of shareholders of a personal-service corporation on its undistributed income, where the corporation elects to be exempt from excess profits tax;
(5) New provisions defining what constitutes earnings and profits of a corporation;
(6) A new excess-profits tax on corporations, for taxable years beginning after December 31, 1939.

The second Revenue Act of 1940 is more difficult to understand than any previous tax law. Rarely does one provision furnish the complete answer to a question. On the contrary, the many cross references divert the reader from one provision to another. The March, 1941, amendments to the excess-profits tax provisions, to be discussed later, have cleared up some of the problems, but others remain.

The rate of normal tax on corporations with normal-tax net incomes of more than $25,000, for taxable years beginning after December 31, 1939, was increased for the second time (in 1940) by the Second Revenue Act of 1940. The new rate of 22.1 per centum, when added to the defense rate of 1.9 per centum, establishes an effective rate of 24 per centum. The 10 per centum defense tax is applied to the rate imposed by the Revenue Act of 1940 and not to the rate imposed by the Second Revenue Act of 1940.

The amortization provision, for both income and excess-profits tax purposes, permits a taxpayer to write off, over a 5-year period, the cost of emergency facilities necessary for National defense. The allowance for such amortization is subject to many qualifications and limitations, some of which benefit the taxpayer; others are designed to protect the interest of the Government. The term "emergency facility" is defined to mean any facility, including land, if completed or acquired after June 10, 1940, and with respect to which a certificate as described in Section 124(f) has been made. The emergency period means the period beginning after June 10, 1940, and ending on the date on which the President proclaims its termination [Section 124(e) (2)]. If the emergency period is terminated in less than 5 years, the amortization period is shortened, but the taxpayer's right to use a 5-year period is not affected by the fact that the emergency period may be longer than 5 years. The amount to be deducted, provided for in Section 124(a), (f), involves too many troublesome details to be discussed here. The taxpayer has a wide range of choice as to the extent to which it will take advantage of the amortization provisions, and may, for years subsequent to choice, make a new election.

The provisions of the Vinson Act (which provides for payment into the Treasury of the excess over a specified period, a specified percentage of profit) were made ineffective (Second Revenue Act of 1940) as to contracts or subcontracts for the construction or manufacture of any complete naval vessel or Army or Navy aircraft which were entered into in any taxable year to which the new excess-profits tax is applicable or would be applicable if the contractor were a corporation (Section 401 of the Act).

The profit-limiting provisions of Section 505(b) of the Merchant Marine Act, 1936, are suspended as to subcontracts which would otherwise be within its provisions, entered into by a corporate contractor with a corporate subcontractor in any taxable year of the subcontractor subject to the new excess-profits tax. (Not applicable to affiliates.)

Amendments to the Internal Revenue Code, specifically made applicable to taxable years beginning after December 31, 1938 (and also made effective for the purposes of the Revenue Act of 1938 or any prior Revenue Act, except as to cases pending before the Board or Courts on September 20, 1940), deal with the determination of earnings and profits of corporations. Earnings and profits which are affected are: (1) those of the corporation as a whole, primarily for invested-capital purposes; and (2) those for any period beginning after February 28, 1913, for the purpose of determining the character of dividend distributions. Corporations which may find it necessary to recompute their earnings and profits because of the new provisions include those which have had transactions such as: (1) sales or exchanges of property acquired before March 1, 1913; (2) exchanges in which no gain or loss was recognized; and (3) receipt of distributions from another corporation.

The Act defines a personal-service corporation as a corporation whose income is to be ascribed primarily to the activities of shareholders who are regularly engaged in the active conduct of the affairs of the corporation and are the owners at all times during the taxable year of at least 70 per cent in value of each class of stock of the corporation, in which capital is not a material income-producing factor (Section 725). A personal-service corporation is subject to the same income tax as an ordinary corporation, but is allowed exemption from the new excess-profits tax if it signifies in its income-tax return its desire for such exemption. Where a personal-service corporation is exempt from excess-profits tax, the "undistributed Supplement S net income" is taxed to the shareholders. "Supplement S net income" is the net income minus (1) the Federal income tax, and (2) a deduction for charitable contributions which is subject to a 15 per centum limitation instead of the 5 per centum limitation applicable to ordinary corporations (Section 393). From the amount so arrived at, dividends paid during the taxable year are deducted in order to determine the "undistributed Supplement S net income" (Section 392). Shareholders are required to include in gross income, as dividends, the amounts which they would have received as dividends if on the last day of the taxable year of the corporation the "undistributed Supplement S net income" had been distributed (Section 394). A shareholder is allowed as a credit, against net income, his proportionate share of the interest on obligations of the United States and its instrumentalities which is included in the gross income of the corporation [Section 394(c)].

EXCESS PROFITS TAX

The most important provisions of the Second Revenue Act of 1940 deal with the new excess-profits tax. First, we will discuss the excess-profits tax as provided for in this Act. Later we will discuss the March, 1941 amendments.

RATES OF TAX

The rate of tax, under the present law, ranges from 25 per centum on the first $20,000 of taxable income to 50 per centum on the amount exceeding $500,000. The amounts of the brackets and the rates of tax are fixed, the same for all taxpayers, and are not graduated on the basis of percentages of invested capital as they were in prior excess-profits tax laws.

EXCESS PROFITS CREDIT

The important problem is the determination of the excess-profits credit. One method of determining the credit is designated as the "income method." Under it the taxpayer is allowed to deduct from excess-profits net income 95 per centum of the average annual excess-profits net income earned during the base period, with adjustment for increases or decreases in capital paid in after January 1, 1940. The second method is termed the "invested-capital method," and under it a taxpayer is entitled to deduct an amount equal to 8 per centum of the average invested capital for the taxable year. Under each method, a specific exemption of $5,000 is allowable. It is not an easy problem to determine the method to be used, for three reasons:

(1) The taxable income for the current year is not determined in the same manner for both the income and the invested-capital methods;
(2) The base-period income is not computed in the same manner as the income for the current year;
(3) The adjustment for increases or decreases in invested capital is not computed in the same manner if the income method is used as when the invested-capital method is used.

Income Method—Section 721 provides that abnormal amounts of income should be allocated over the period of years to which it is applicable. Should any portion of such abnormal income be applicable to the base period, a question arises as to whether or not the base-period income should be increased thereby. The report of the Senate Finance Committee, which introduced the bill first containing the abnormality relief section, states that the base-period income would be increased, yet neither the relief section nor the section dealing with the determination of the base-period income provides specifically for such inclusion in the base-period income.

The base-period years are the taxable periods beginning after December 31, 1935, and before January 1, 1940—normally, the 4 calendar years, 1936 through 1939. However, by reason of changes in fiscal reporting periods, the base period could include more or less than forty-eight months.

The right to use the income method is available to all domestic corporations which were in existence before January 1, 1940. However, if a taxpayer meeting that requirement was not in existence for 48 months preceding the beginning of the first taxable year under this Act, it is given a "constructive" income for the period preceding its incorporation. This constructive income is 8 per centum annually of its invested capital at January 1, 1940, or at the beginning of the first taxable year under the new law, if a fiscal year is used. In determining invested capital for that first day, the percentage adjustment for inadmissible assets is based on the ratio of inadmissible assets to total assets for the preceding taxable period—not the ratios on that first day. Having determined the "constructive" income for the period prior to existence (note that an existing but inactive company does not get the benefit of it for the inactive period), such "constructive" income is brought into the computation of the average base-period excess-profits net income, along with actual income, if any, for its period of existence.

Under the income method, the credit consists of:

(1) 95 per centum of the average annual base-period excess-profits net income determined in the manner described,
(2) Plus $5,000 specific exemption,
(3) Plus 8 per centum of net paid-in capital additions after the beginning of the first excess-profits tax year, or
(4) Minus 6 per centum of the net paid-out capital reduction.

As to the adjustment for capital additions or reductions, the following is to be noted:

(1) No consideration is given to increases or decreases in accumulated earnings by reason of gains, losses, or taxable dividend payments.
(2) No consideration is given to increases or decreases in borrowed capital.
(3) Increases in paid-in capital (reduced by increases in inadmissible assets) or decreases through distributions of capital are considered only if they occurred after the start of the first excess-profits tax year (January 1, 1940, in the case of calendar-year companies).
(4) No consideration is given to stock dividends or stock rights even if they are of a taxable nature.

The method of recognizing capital changes presents some odd possibilities which seem hardly justified in a taxing statute. The first is that no recognition is accorded changes prior to 1940. Thus, a calendar-year company into which additional capital was paid on December 31, 1939, receives no benefit, but had it been paid in on January 1, 1940, its credit would have been increased by 8 per centum thereof. No adjustment is required for changes in inadmissible assets if no additional capital is paid in (even though dividends are not taxed). Thus, a corporation averaging, say, $100,000 during the base period, and having then no inadmissible assets, might acquire some, increase its income as a result, and yet pay no tax. Conversely, if a corporation which earned no base-period excess-profits net income, as defined in the statute, but earned $100,000 through dividends, should dispose of its stocks and earn its profit through ordinary business operations, it would have no credit on the income basis. It would be forced to use the invested-capital method, which might result in an excess-profits tax even if the current-year income were less than the base-period average actual earnings. The only effect of changes in inadmissible assets is to offset additional capital paid in—and then it is not material whether or not the new capital was used to acquire the additional inadmissibles. Furthermore, the adjustment for new capital will change every time there is a change in inadmissibles. And finally, no adjustment is allowed for decreases in inadmissibles when a capital reduction is effected. So, though inadmissibles paid in as additional capital would not increase the credit (and properly so), inadmissibles distributed as a return of capital would decrease the credit (despite the fact that such a distribution would in no way affect the excess-profits net income).

Under either method of determining the excess-profits credit, it will be necessary to re-examine the taxpayer's books for prior years. If the earnings method is used, such re-examination will be required as to 1936 and subsequent years. Under the invested-capital method, it may be necessary to examine all years beginning with the organization of the corporation.

Invested-Capital Method—Under the invested-capital method, "the excess profits credit . . . shall be an amount equal to 8 per centum of the taxpayer's invested capital for the taxable year." For the purpose of determining the excess-profits credit, invested capital may be defined as the "daily equity invested capital" plus the "daily borrowed capital." However, the proper determination of these two items constituting "invested capital" may involve exhaustive examination of the taxpayer's records.

Capital paid in plus realized earnings retained in the business generally will constitute "equity invested capital," though in many cases other items will influence the statutory determination thereof. The following summarized definition of "equity invested capital" seems to be fully supported by the statute:

(Sec 718) (a). The equity invested capital for any . . . year . . . shall be the sum of . . .

(1) Money paid in for stock, or as paid-in surplus, or as a contribution to capital;
(2) Property paid in for stock, or as paid-in surplus, or as a contribution to capital;
(3) Accumulated earnings and profits as of the beginning of the taxable year;
(4) Distributions in stock of the corporation's own issue out of earnings and profits accumulated prior to the beginning of the taxable year; and
(5) Gain on tax free liquidation of a subsidiary.

(Sec 718) (b). From the sum of the foregoing, there should be deducted:

(6) For the calendar year 1941 and subsequent years but not for the year 1940, distributions made during the first sixty (60) days of the taxable year;
(7) Distributions made prior to the taxable year which were not out of accumulated earnings and profits;
(8) Distributions made during the taxable year which are not out of the earnings and profits of such taxable year;
(9) Earnings and profits of another corporation which previously were included in earnings and profits of the taxpayer by reason of acquisition through a non-taxable reorganization;
(10) Reduction on account of loss on tax-free liquidation.

Money paid in for stock, or as surplus, or as a contribution to capital does not require discussion here.

Property paid in shall be included in equity invested capital at its income-tax basis, which means its basis for determining loss upon sale or exchange. Such basis will be cost or value when acquired, unless it is acquired in connection with a transaction under which a predecessor owner's basis must be carried forward.

Property paid in is includible at its value when paid in, which may be in excess of the par value of the stock issued therefor. If property is purchased for $50,000 and the purchaser immediately transfers it for stock having a par value of $25,000, the amount to be included in equity invested capital is $50,000.

Let it be emphasized here that the language of the statute is: "Paid in for stock, or as paid-in surplus, or as a contribution to capital." Under prior law it was held that amounts contributed to taxpayer by prospective patrons towards the cost of constructing extensions of existing facilities to the premises of the contributors may not be included in invested capital. (Tampa Electric Co., 12 B.T.A. 1002.) It seems clear that amounts paid in by non-shareholders are not to be included in equity invested capital.

A feature in the new law is that intangibles paid in for stock are includible at full value when acquired. Under the old law such assets were includible at full value in an amount not in excess of 25 per centum of the total capital stock outstanding.

Notes receivable given in purchase of capital stock represent property paid in for stock. In Hewitt Rubber Co., 1 B.T.A. 424, the Board held that an interest-bearing demand promissory note of a responsible maker, in good faith paid in for capital stock, constitutes invested capital, to the extent of its cost value at the time paid in. Where the note, the value, and the intention to pay are bona fide, the value is includible in equity invested capital.

A stock subscription agreement of itself is not property and was not regarded as such under the invested-capital provisions of prior revenue acts. A corporation may not include in invested capital the amount of unpaid subscriptions to its capital stock. (Central Consumer's Wine & Liquor Co., 1 B.T.A. 1190.)

Accumulated earnings and profits as of the beginning of the year are to be included in equity invested capital, but it might be noted that there is no deduction for an accumulated deficit. In determining the true amount of accumulated earnings and profits, it may be necessary to examine the taxpayer's old records and look for written-off asset values. If conservatively managed corporations have written off purchased good will and organization expenses, the amounts thereof should be restored. It has been held that the deduction, concurrently, as operating expenses, of amounts expended in the development of patents and processes does not bar their restoration to surplus upon a clear showing that they were in fact capital expenditures. (Goodell-Pratt Co., 3 B.T.A. 30.)

Amounts expended for plans, drawings, tracings and patterns have been held to constitute capital expenditures, and the depreciated cost thereof should be included in invested capital. (Coatesville Boiler Works, 9 B.T.A. 1242.)

Adjustments to the book balance for earnings and profits may, in some cases, operate to reduce the amount includible in equity invested capital. Decreases in statutory surplus would result from elimination of unrealized appreciation, and reduction for property depreciation sustained but not taken into account on the books.

In the case of the previous receipts of property by the taxpayer in complete liquidation of a subsidiary, under section 112 (b), (6), there is to be included in the equity invested capital the excess of the basis of the net assets received in liquidation over the basis of the stock surrendered therefor. This item has been referred to as the "gain on tax-free liquidation" but it is really not the gain which may have been realized by the parent corporation, because the yardstick is not the value of the property received but the tax basis of the net assets received. The following example illustrates the point:

Money received plus tax basis of all property (other than money)		$100,000
Less:		
Basis for stock surrendered	$70,000	
Liabilities assumed	10,000	
Liabilities to which property was subject	5,000	85,000
Amount to be added to equity invested capital		$ 15,000

Assume that the money received plus the value of the other property aggregated $200,000, the gain would be $115,000, although equity invested capital would be increased only $15,000.

For the calendar year 1941 and later years, all distributions made during the first 60 days of the taxable year will reduce equity invested capital to the extent that such distributions do not exceed accumulated earnings and profits at the beginning of the year. This reduction is effective as of the beginning of the year. It appears that where distributions made during the first 60 days of the taxable year are in excess of the accumulated earnings and profits as of the beginning of such year, the excess distribution will be a charge against current earnings, and, to the extent current earning are available, such excess will not operate to reduce daily equity invested capital. To illustrate:

Earnings and profits at 1-1-1941	$50,000
Distribution 2-28-1941	70,000
Excess of distribution over accumulated earnings at the beginning of the year	20,000
Earnings for 1941	40,000
Reduction in invested capital (as at January 1, 1941)	50,000

Distributions made prior to the taxable year which were not out of accumulated earnings and profits operate to reduce invested capital. Thus, a deficit created by distributions will reduce equity invested capital, though an operating deficit in earnings and profits will not. Unless there is a deficit in surplus (accumulated earnings and profits) at the beginning of the taxable year, ordinarily it will not be necessary to search for capital distributions, inasmuch as such distributions will have lodged in the surplus accounts.

Distributions made during the taxable year, not out of earnings and profits of such taxable year, will reduce equity invested capital. Such distributions will arise from distributions made during the first 60 days, and from distributions made after the first 60 days in cases where earnings and profits of the taxable year do not equal such distributions. The following illustrates the latter situation:

Distributions after the first 60 days	$60,000
Earnings and profits for the taxable year	40,000
Amount to reduce daily equity invested capital	$20,000

It should be remembered that we are dealing with the average equity invested capital for the year. If no changes occur during the taxable year—if no new capital is acquired and no distribution of capital is made—then the equity invested capital as of the beginning of the year will be the average equity invested capital for the year, except for adjustments, if any, for inadmissible assets.

Borrowed capital is to be included in invested capital in an amount equal to 50 per centum thereof. Borrowed capital is the amount of outstanding indebtedness evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust.

Inasmuch as invested capital is subject to daily increase, borrowed capital will affect invested capital immediately. The definition of borrowed capital contains the following language: "The borrowed capital for any year . . . shall be . . . the sum of . . . : (1) the amount of the outstanding indebtedness . . . of the taxpayer which is evidenced by a bond, note, bill of exchange . . ."

Under the above language, it appears that notes payable for merchandise, supplies, and equipment will be includible in borrowed invested capital.

The law provides no option as to whether the amount of borrowed capital shall be included or omitted from the computation of invested capital. It must be included, and 50 per centum of the interest paid thereon must be excluded from deductions in computing excess-profits net income.

Section 720 provides for reduction in invested capital for inadmissible assets. Inadmissible assets are those securities the income from which is exempt for excess-profits tax, such as Federal and State bonds and stock of other corporations. It is provided in Subsection (c) that inadmissible assets shall become admissible assets if, during the taxable year, short-term capital gains are realized thereon.

A taxpayer, under Subsection (d), for any taxable year, may elect to include in its admissible assets for such taxable year securities described in Section 22 (b) (4), by including the income therefrom in excess-profits net income. This option does not apply to corporate stocks owned.

Time does not permit a discussion of all provisions. However, in passing, the following should be noted so that they will not be overlooked in situations to which they may apply:

(1) Consolidated returns may be filed for excess-profits tax under rules and regulations to be prescribed by the Commissioner.
(2) There are numerous and very complicated provisions relating to exchanges, mergers and consolidations.
(3) Personal-service corporations meeting the test of the law may elect to be exempt from excess-profit taxes, provided the normal tax net income, less the income tax thereon and also contributions up to 15 per centum of the net income (instead of the 5 per centum limit applicable for income tax purposes), is reflected in the personal-tax returns of the shareholders.
(4) The determination of accumulated earnings or profits for both income-tax purposes and invested-capital purposes has been more specifically defined.
(5) Certain types of corporations, which I shall not attempt to list, are exempt from excess-profits tax.
(6) Provision is made for the amortization of the cost of facilities acquired in connection with the defense program.

MARCH 1941 AMENDMENTS

Now let us consider the March, 1941, amendments. Briefly, the changes are:

(1) A corporation may elect to capitalize advertising and good will expense deducted from income during the base-period, subject to income-tax adjustment.

(2) A corporation which is a dealer in securities shall include in admissable assets corporate stocks held for resale. Dividends on stocks so treated are subjected to the excess-profits tax to the extent that they exceed the credit provided in section 26 (b) of the I.R.C. (Credit 85 per centum with limitations).

(3) New provision requires an addition to or reduction of the excess-profits tax on account of an inconsistent position in computing excess-profits tax, as compared with the treatment of an item in the income-tax return for prior taxable year or years.

(4) Adjustments are permitted to restore to base-period income any abnormal deduction. A standard of measurement is provided to determine whether or not a deduction may be classed as abnormal.

(5) To provide an alternative method of computing base-period income for purposes of income credit. The base period is to be divided into two periods: the first to be the years 1936 and 1937; and the second, the years 1938 and 1939. If the income for the second period is higher than for the first period, the taxpayer may use the alternative credit. Divide the difference in averaged income for the two periods by two and add the resultant amount to the second period averaged income to determine the permitted credit. To illustrate:

Income:

For 1936, $15,000; for 1937, $25,000; averaged	$20,000
For 1938, $30,000; for 1939, $50,000; averaged	40,000
Difference in income for the two periods	20,000
Divide the difference by two	10,000
Add the averaged income of second period	40,000
To obtain permitted credit of	50,000

(6) New Section 722 permits an adjustment where there is a difference between the type of business carried on in the base period and the business during the taxable period.

(7) Corporations may be required to restore to income or capital certain advertising expenses deducted during years in the base period. Also, they may be required to capitalize similar deductions in 1940 and subsequent taxable years.

(8) Provision is made for reduction of excess-profits net income of the taxable year for any type of abnormal income which is attributable to taxable years in the past or future.

(9) Credit under income or invested-capital method now permitted without binding election. This applies to corporations which were in existence prior to January 1, 1940. Computation of the credit under

both methods is required except where the taxpayer specifically disclaims one of the methods.

(10) Insurance companies, other than life or mutual, are permitted to file with an affiliated group of non-insurance companies.

(11) In cases involving the restoration of abnormal deductions during the base period, abnormal income of the taxable year or the correction of abnormal situations during the base-period years, the Board of Tax Appeals has exclusive jurisdiction, and its decisions are not reviewable by the Courts.

(12) The amount of the unused excess-profits credit for any taxable year may now be applied to the succeeding two years, for all corporations, in lieu of the one-year carry-over allowed corporations with normal net income not in excess of $25,000.

(13) Certain classes of reorganized corporations are permitted to use the base-period income experience of predecessor corporations. A new provision classifies partnerships and sole proprietorships as corporations, so that their income experience may be reflected in the average base-period net income of the reorganized acquiring corporation.

(14) Reorganized corporations which were in existence prior to January 1, 1940, can elect to use the method of computing excess-profits net income under Section 742 or the income-credit method as in the case of ordinary corporations.

(15) As in the case of taxpayers using the invested-capital method, a new provision has the effect of increasing or reducing the excess-profits tax on account of an inconsistent position in computing excess-profits tax, as compared with the treatment of an item in the income-tax return for a prior taxable year or years.

REVENUE ACT OF 1941

What is ahead of us, no one can predict with certainty. We will have the "Revenue Act of 1941" and probably the "Second Revenue Act of 1941." On April 21, the Ways and Means Committee met in executive session and heard Mr. John L. Sullivan, Assistant Secretary of the Treasury, present the Treasury Department's suggestions. The proposals were made public on April 24, and included the following: Normal Tax on individuals to remain at the present level; Surtax at 12.1 per centum to begin after exemption and credits; in addition to present corporate income tax and excess profits tax, a new surtax of 5 per centum on the first $25,000 of income and 6 per centum on the balance. Congressional experts have recommended no change in existing normal tax, in exemptions and credits, and less drastic increase in surtax in lower brackets.

Some experts predict that the excess-profits tax will be higher—that credit under the "invested capital" method will likely be reduced from 8 per centum to 6 per centum, and under the "average earnings" method from 95 per centum to 75 per centum, of base-period income—and that rates will be upped to a top of 65 per centum or 75 per centum. It appears that general exemption under Estate and Gift Taxes will be reduced from $40,000 to $25,000; likewise, the special insurance exemption will be reduced from $40,000 to $25,000. A long list of new "excise" taxes, and increases in nearly all existing excise taxes, has been proposed by the Treasury.

Time will not permit discussion of decisions by the Board and the Courts that give rise to tax problems: The Clifford case, involving trust income; the Hallock case, involving trust property; the Bruun case, involving taxation of a lessor upon improvements made by his lessee; the Higgins case, involving deductions against taxable income in the case of an inactive investor; and the Bailey cases, involving insurance proceeds. In the Bailey cases, the same Court rendered three differing opinions within a period of some 12 months. To emphasize the importance of the problems growing out of Court decisions, it is pointed out that the Hallock decision by the Supreme Court was contrary to all precedent. In a dissenting opinion, Justice McReynolds said:

> To upset these precedents now must necessarily shake the confidence of the Bar and the Public in the stability of the rulings of the Courts and make it impossible for inferior tribunals to adjudicate controversies in reliance on the decisions of this Court. To nullify more than fifty decisions, five of them by this Court, some of which have stood for a decade, in order to change a mere rule of statutory construction seems to me an altogether unwise and unjustified exertion of power.

Taxpayers appearing before the House Committee hearings on the 1941 Tax Act are making sharp attacks upon the Higgins, Hallock and Bruun decisions, and are requesting amendments to the law to correct what seems to be a bad situation.

In conclusion, may I say that day by day the Courts are adopting a more realistic approach to tax problems. As has been said, they will seize every opportunity to slash through form to reach substance—pierce the veil of legal fiction to charge the tax against the party who in fact enjoys the taxable privilege of property.

CHAIRMAN STEMPF: Thank you, Mr. Phillips. I want to thank both of you gentlemen; and at the same time I want to warn both of you that those who speak in public must be prepared for the consequences. And I want to remind the audience of its right to tear the speakers limb from limb!

Mr. Phillips, your paper reminds me of the story Joe Heckert told one time concerning two colored preachers. One moved out of the town and the other came to take his place. He found a file of the first preacher's sermons, voluminously annotated. One of them was marked, "Shout like hell here—

this point is weak!" My reference is, of course, to the weakness of the law, not to your interpretation of it.

Mr. Camman, I have just one comment: I do honestly challenge the inherent soundness of the exclusion from the price structure of escalator amortization. The whole concept of the provisions looked back to the last war, after which we found ourselves with a lot of excess facilities. If that danger is to be avoided, the cost of these facilities should be recoverable through the price structure.

MR. CAMMAN: My understanding, Mr. Chairman, is that, at the time the amendment to the Internal Revenue Code was considered, it was the desire of the legislature to try to avoid procedures under which all the financing of new plants and plant extensions would have to be done by the Government. The risk in such a course is that after the period of emergency is over we would have a large number of Government-owned plants. The amended clause (Section 124) was introduced in order to induce private industry to invest capital for the building of the needed additional emergency facilities. The wording of this amendment does not express the intent that the contractor should recover the entire cost of his investment in additional facilities in a five-year period. It offers him the opportunity to amortize, by deduction for income tax purposes, the cost of his plant in a five-year period. It seems to me that in this provision the Government definitely offered a bargain to private investors to put forth their capital in the construction of additional facilities and recover part of it through tax deductions and depreciation, so that at the end of the five-year period the investor would own a plant at some fraction of its original cost for what use it might then prove to be. For example, if a contractor invests $100,000 in emergency facilities and receives tax amortization while he is, let us say, in a 50 per cent tax bracket, he benefits by tax deduction to the extent of $50,000, and in addition he recovers, in the price of supplies sold during the five-year period, normal depreciation to the extent of, let us say, an additional $30,000, which, less tax, leaves $15,000, so that at the end of the period of emergency of five years he would own a plant in which he has a remaining investment of $35,000.

The Government protection clause—Section 124 (i)—was put in to prevent the contractor from both taking tax amortization and including amortization in his price of supplies, in which case he would recover all that he actually spent, while the Government has no protection for its interest in the plant to which it contributed.

CHAIRMAN STEMPF: That is an excuse, but not an explanation.

QUESTION (From the floor): I assume from the law that land as well as buildings used for the emergency facilities can be amortized?

MR. CAMMAN: Land is specifically mentioned as among the emergency facilities subject to amortization.

MR. LOGAN MONROE (Eaton Mfg. Co., Cleveland): I haven't had a chance to figure out the sense in the stipulation that you are not to include amortization in tax. If the Vinson Act were in force, I could undersand it.

MR. CAMMAN: There is a good deal of confusion in the wording used in the law, especially in Section 124 (i), which causes some very serious problems. The Act says in effect that there shall not be included in the price of supply contracts any provision for the recovery of investment in emergency facilities greater than normal exhaustion, wear and tear. In some cases this might call for a breakdown of price in order to ascertain what elements were included therein at the time of entering into the contract.

MR. WALTER A. ROWE (Commissioner of Accounts, City of Cleveland): I don't have anything to add, but I have a question. Mr. Phillips, you commented on the desirability of going back and finding goodwill, organizational expense, etc., that might be restored to the accounts, and also the possibility of going back and capitalizing expenses of advertising in the past in order to take advantage of them in invested capital. Very few people will do this because of the joker, restoring advertising expense in order to take 8 per cent in the future and never having a chance to amortize it. Do these expenses as restored have to be restored in the accounts proper? If so, what will be the effect on the statements in the future?

MR. PHILLIPS: I don't think it will be necessary to restore them to the books in order to give effect to them in the excess-profits tax return. No one can tell until the individual case has been studied whether or not the restoration to capital account of such expenditures will benefit a tax payer. That is what I had in mind when I said some moments ago that we will all have to do more work in connection with the preparation of excess-profits tax returns in the future.

MR. ROWE: I was disturbed at having to restore them to the accounts and present them to the public as part of the statements. I was not sure but that that might be necessary.

MR. PHILLIPS: I do not understand it that way. This is simply a relief measure. Advantage of restoration, if there is any, can be taken in the excess-profits tax returns without actually restoring the expenditures to the accounts in the books and to the financial statement.

FOURTH SESSION

FRIDAY, MAY 16, 1941 — 7:00 P. M.
The Faculty Club (Dinner Session)

Chairman:

WALTER C. WEIDLER, *Dean, College of Commerce and Administration, The Ohio State University, Columbus*

Greetings:

HOWARD L. BEVIS, *President, The Ohio State University, Columbus*

JOHN L. CAREY, *Secretary, The American Institute of Accountants, New York*

STUART C. MCLEOD, *Secretary, The National Association of Cost Accountants, New York*

Subject: "Current Problems"

Speaker:

DAVID FRIDAY, *Economic Consultant, Washington, D. C.*

INTRODUCTORY REMARKS

By WALTER C. WEIDLER
*Dean, College of Commerce and Administration
The Ohio State University*

These are confused days, and it is highly gratifying to the College of Commerce to see that so many of you accountants can find time to come here to such a meeting. You face a great many difficult problems—problems of a large prospective increase in your normal load, problems incidental to defense contracts, etc. I suppose your problems are still more complicated by the fact that you will have to meet the increased responsibility with personnel less effectively trained than you have been able to rely upon in the past. You must face the job of training people whose training has progressed only in a limited way.

I suppose you will need, along with businessmen in general, an almost unlimited energy in order to draw these men from partly trained ranks and train them so that they will be able to function effectively. It reminds me of a story I heard about an old Swedish farmer who visited Minneapolis for the first time. He chanced upon his first elevator. As he stood looking at it, a very ugly woman got in, and the door closed. He stood there. By and by the door opened, and out stepped a beautiful woman. "By golly," he said, "I think I bring the old woman down and put her in." I guess you accountants will have to put plain people in and pull out good junior accountants.

It is a pleasure to see you here, a greater pleasure because I see so many familiar faces. I hope you will find your stay here pleasant and profitable, and that I will see you here again next year.

I am happy to present to you Abner J. Starr, Secretary of the Ohio Society of Certified Public Accountants; Leonard Park, President of the Ohio Society of Certified Public Accountants; Henry T. Chamberlain, President of the American Accounting Association; Jacob B. Taylor, Head of the Department of Accounting here at Ohio State University and Head of the Liquor Division of the State of Ohio; Victor H. Stempf, President of the National Association of Cost Accountants; Hermann C. Miller, of the Department of Accounting, who is at present working with the Navy; and Ernest Sarrey, President of the Ohio State chapter of Beta Alpha Psi. The fraternity has labored diligently in connection with this meeting.

Now I should like to present our President, Howard L. Bevis. President Bevis has had an interesting history from the viewpoint of this group. He has been a professor of law at the University of Cincinnati, later a member of the State Supreme Court, and subsequently a professor at Harvard University. He is a man whose varied experience leads me to believe that he has a great deal in common with you accountants. President Bevis.

GREETINGS

By Howard L. Bevis
President, The Ohio State University

John L. Carey
Secretary, The American Institute of Accountants, New York

Stuart C. McLeod
Secretary, The National Association of Cost Accountants, New York

President Bevis: For a man who always has trouble getting his bankbook figures to balance, I get along very well with accountants.

May I say how much we at the University appreciate these annual events. We are glad to see so many of the accounting profession here. It helps us market our students; it puts us on a friendly basis with your profession; and it gives us an opportunity to try to help you. May I use the authority vested in me to extend to you a hearty welcome from the University.

Chairman Weidler: Thank you, President Bevis. Now, I should like to present the Secretary of The American Institute of Accountants, Mr. John L. Carey.

Mr. Carey: I think everyone will agree with me that this conference has been a splendid success. I have listened to about thirty-five discussions of accounting principles, but I never have heard one more interesting than that at this morning's session. I held myself back from contributing to the discussion only when I remembered the story of the sparrow who came home to the nest one night with his feathers all ruffled and battered. Said his wife, "Why, dear, what has happened to you?" "Why," said the sparrow, "I was just coming home from a little innocent fun with the boys when something hit me, and when I managed to pull myself together I found I was in the middle of a badminton game."

According to the program, my name appears under the heading of "Greetings." I thought I would find out what "Greetings" are, so I looked in the dictionary. I found that in Scotland greetings can be a cry of sorrow, so I looked farther down the page. I found that an early meaning of the word was "to annoy," so I didn't stop there. Farther down I found the correct meaning, "to salute." I therefore salute you, accountants! I do it with a particular enthusiasm, because these meetings have been among the very first to bring together teachers and students and public and private practicing accountants. I have thought for years that the quicker these three or four groups of accountants could become well acquainted, the quicker all would get ahead. And I am supported in this view by the national professional accounting organizations and even by the S.E.C.

Since members of the American Accounting Association, the National Association of Cost Accountants, and the American Institute of Accountants are meeting here, I would like to speak very briefly about the program of one of these groups, the American Institute of Accountants. Very briefly, its viewpoint is that of the public practitioner. The program we are trying to accomplish fits in with what other organizations are trying to do, and yet emphasizes the maintenance of professional accounting standards, the uniting of all Certified Public Accountants in the United States, and the informing of the public about accounting.

Carrying out these aims involves a great deal of activity. In connection with the first goal, the maintenance of accounting standards, we have to think about not only accounting procedure but standards for admission to the profession. We try to help the Certified Public Accountants' societies of the various states. Then, in connection with ethical standards, we do a great deal of work that never sees the light of day, because it is confidential. The Institute studies court decisions, institutes disciplinary action when necessary, etc.

Our second objective is the attempt to work with state organizations. In a brief six years, tremendous progress has been made in this direction. Part of this objective involves the dissemination of information. Our principal channels for supplying information are the libraries. We are reaching a great many people through the *Journal*.

The third objective is accomplished in part by committees working with outside committees with related interests. Other aspects of the public information work are the usual ones—the radio and press, speakers bureaus, etc.

Sometimes I become smug about what we have done, but then, looking at what might be done, I realize that the surface has not been scratched. I know that there is no one man or firm or committee that can make accounting in this country the force that it should be. Thousands of accountants, each in his own field and in harmony with others, may accomplish the desired result.

CHAIRMAN WEIDLER: Thank you, Mr. Carey. Our next speaker needs no introduction. Any group of accountants, meeting anywhere in the country, knows Dr. Stuart McLeod, Secretary of the National Association of Cost Accountants. Dr. McLeod.

Dr. McLeod: I want to thank you most sincerely for the hospitality which has always been extended to me at these institutes. Tonight you have even gone beyond yourselves. You have given me a characteristic Scotch reception—even the atmosphere is close!

In spite of your hospitality, I feel embarrassed appearing before you for the fourth time. I think many of you must feel toward me like the man felt who called the doctor and said his wife had dislocated her jaw. He asked the doctor to stop in if he were going by that way in the next two or three weeks. Having attended these institutes for four years, I suppose it is time I were graduated, but, with the permission of the College, I should like to return for post-graduate work.

I think you have had a very interesting and constructive program. I have just one criticism. Programs of this nature, with which I have long been acquainted, are like women's hats. The technical subjects run in waves of fashion, and this institute has overlooked the current very important subject, "The Responsibility of the Accountant." The responsibility of the accountant has been served to me every day with my orange juice. Personally, I know only one thing about it. I don't know whether accountants are responsible for pay roll, or for inventory, or for this or that, but I *do* know the accountants are responsible for one thing—and that is me! Not so many years ago I was a wholesome, clear-eyed young college professor, teaching the science of government to the young men of Harvard College. When I think of the doctrines of sanctity of the Constitution, and partition of power, and checks and balances that we tried to impart to those gentlemen, I could not look them in the eye if I saw them on the street today. If I had not fallen under the accounting influence I would have a job by now like Dean Weidler has. But I fell, and before you stands this piece of human wreckage for which you are responsible.

I suppose that I have got to say something serious, and I have something serious to say. In this present situation in which we find ourselves, we are hearing a great deal of talk about our defense program, and I sincerely believe it is necessary. In fact, I could get along with a little more speeding up of production.

The point I have in mind is this. Of all the peoples in the world, I think our people have the greatest possibility for hysteria. We get sold on an idea until we go crazy. You may recall prohibition as a good example of what I mean. Now we are going to town with the idea of speeding up production, and I hope that everyone of you who can exercise power will do everything you can with the managements of industry to impress upon them the necessity of maintaining costs and cost records. It is quite true that in times like these we cannot hope to maintain the normal relation between costs and production. There will be production at extravagant cost, but there is a point where, under any circumstances or emergency, it does not pay to produce. You reach the point where cost of production exceeds the value of the product produced. Unless we maintain a relationship between volume and cost we will only lay up trouble and write a debt which will have to be paid. Even if we have an emergency, we must still keep in mind the cost of production. That is the thought that I would like to leave behind me.

I want to thank all my friends for having me here again. When I say to you that our association considers it a privilege to cooperate with you, I mean it. We do not want you to thank us—we thank you. You have contributed substantially to the accounting profession by these institutes.

CHAIRMAN WEIDLER: Thank you, Dr. McLeod. Our speaker of the evening is Mr. David Friday. Mr. Friday began his career as a Professor of Economics at the University of Michigan, and later was President of Michigan Agricultural College. He has made a great place for himself as economist and tax consultant. Mr. Friday.

CURRENT PROBLEMS

By David Friday
Economic Consultant, Washigton, D. C.

When Dean Weidler first asked me to come here, I thought I would give you a talk on the international distribution of economic power. On second thought I decided you might prefer to hear something about prices during and after the war. Then I realized how difficult a subject it is. Nobody really knows anything about it.

First, let me tell you something of the difficulties we run into in discussing this subject. In order that you may not be deceived at all regarding what the economist knows about prices, let me say just a word about the sort of price history a man lives through. The earliest recollection I have is of that famous political campaign of 1896, with Bryan on the Democratic ticket. Prices had been declining until at that time they hit a record low for all time. The price index in 1896 stood at 46. We defeated William Jennings Bryan by saying that if the people elected him and got free silver we would have the silver dollar. When we defeated him we thought we were nailing the price level down. So we all got out and defeated the Democrats. We got the Republicans into power, and maintained the gold standard. Prices started to go up, and went up from 46 to 70. That was the first experience I can remember with prices. The Democrats never reminded us of it. If you want to have some fun with the Republicans, or with economists who are still Republicans, ask them about it.

The war broke out in 1914, and while it was a settled proposition that war brought a rise in prices, prices didn't rise for a year. Then they went up and up, until at the end of the war in November, 1918, the price level had risen from 70 to 136. It was 122 in the summer of 1917. At 136, the index was about 80 per cent higher than at the beginning of the war. Then we predicted that we would have a depression. Washington was not worried about who would win the war, only about the depression. We thought surely we would have a fall in prices, but they went up again, to 167.3. By May, 1920, the price level had risen until it was 2.4 times as high as when the war started. I was not one who predicted that prices would fall, but lots of good people did. It was generally believed that prices were going down and would return to the level of 1914, to 67 from

167. They did have a great fall in the summer of 1921, from 167 down to 91, but then they leveled out to 103 in 1923.

Using 1926 as the basic year of 100, we had prices of wholesale commodities leveling out in the United States. All through the 1920's we had a price index which was not much above 100, and, in general, tended downward. But at any rate, prices kept on falling a little. By 1929 the index stood at 97. Price inflation was not evidenced in commodities—they were not as high as in 1923. In the spring of 1933, prices slipped down to 60. And then we got a new government in Washington, and did various things, and were determined to put prices up. We devalued the gold dollar and expanded credit. The President made a public speech and said we would put the index back to 100, but it did not go up. It got up to 88 in 1937, and then slipped off again. By August, 1938, it had gone down to 75 again. So that is the contemporary history of the price level: 1896, with 1926 as the base year, 46; 1913, 70; 1914, 67; 1917, 122; 1918, 136; 1920, 167; then 90 and 103 and 97, until in 1927 the index stood at 95; at 97 in 1929; at 60 in the spring of 1933; at 88 in 1937; and at 75 at the outbreak of the war.

In those years we economists learned that some of the things we accepted as true from our professors were not necessarily true. For instance, in school we learned that the price level depended upon the standard. If you removed just half the gold content of the dollar, the standard would be just one-half as high. But on January 30, 1934, we did reduce the dollar from 100 to 60 units of gold. And what happened to prices? Not a thing happened to prices! And you accountants were no smarter than the others. I am telling you quite frankly that the world knows very little about prices. I am ancient and independent, and I can stand up in these halls and tell the truth. Dean Weidler could say the same thing, because he has a long-term contract.

What is going to happen to prices? Six years from now I may be all wrong. Whenever I make a prediction, I always think of Henry Riggs, Head of the Department of Engineering at the University of Michigan back in the good old days. He had a little electricity-making machine in his laboratory, but he was thoroughly convinced that electricity would never be anything but a plaything. Then in 1893 we went to the Fair and saw the magnificent illumination. And at evening when all the lights went up I said casually, "Professor, do you remember that old machine in our laboratory?" And he said, "shut up!" It will be that kind of an occasion when you see me and remind me of what I said this night. Yet it gives me great pleasure to remember that the last time I spoke here I predicted that the United States would arm and that it would bring an increase in production and stamp out unemployment. I was right that time.

Is there anything unusual in prices going up in time of war? I think not. Some people think it indicates something terribly wrong with the industrial structure. I don't see anything unusual about it. It is the result of supply and demand. The effective demand means simply the amount people are willing to buy of a certain thing at a certain price. Whenever war breaks out, one thing that the nation wants is goods—raw and finished. Once those needs are supplied, there is the government demand for things needed to pursue war. And government has purchasing power, so that it can make its wants felt. They bid for the things they want, and it brings about an increase in prices. In the War of 1914, as I said, it was fifteen months before prices went up. This time they are behaving in the same way. War broke out on September 1, 1939, and until late in 1940 prices rose very little. They popped up a little at first and then went down. Then they went up and have been continuing to go up because the government is demanding and needing goods. It is taking $350 million from us in taxes, so it can buy.

I was one of those who planned the taxes in the last war—excess-profit taxes, surtaxes, nuisance taxes. I planned them. I made them for state governments and federal governments, and they were never popular. But I want to say here and now, I never made a tax that did not raise the money. Whenever people kicked, they just were told to buy government bonds. But as I say, government can get its purchasing power, because it has the taxing power. It can take our savings by bonds, or it can sell the banks' bonds and create deposits. The government's credit is good. We have the ability to put purchasing power at the disposal of government. The individual or corporation demands raw material, or what not, as long as it is possible to sell products at a profit. If corporations cannot make products at a profit they will not buy. But the government does not have the profit motive at heart, and so will buy regardless of prices. Beating the enemy becomes an end that is absolute. It is the very nature of the demand. So there is nothing surprising in a rise in prices.

How much have prices gone up? The Bureau of Labor Statistics wholesale-commodity index has gone up from 75 to 83.2. There is also a set of index numbers based on spot prices, the index for the 28 basic commodities which the Bureau of Labor Statistics gets out each day. That index has gone up a great deal more than 11 per cent. If you take the figure of wholesale prices in August, 1939, as 100, the prices of the 28 commodities—wheat, cotton, etc.—have gone to 142. Now, it is my guess that an advance of 42 points is nearer the truth than the 11 per cent represented by the rise from 75 to 83.2 in the other index. That is, prices have gone up. They are probably higher than 142 now. In important industries, prices have gone up more than 50 per cent. A large amount of the advance has occurred in the last year.

And after the War, what? I am very confident that I am right here, more so than I am of the prediction that prices will rise to 100. After the first war we thought they would have another rise, and they will this time, especially if we sell the people bonds or go further and pay off the wage earners with bonds instead of wages, as has been suggested. Then the people will have a great mass of bonds. They will sell the bonds and spend the money. They will have purchasing power for houses, automobiles, etc., especially if they have been restrained from buying commodities, and prices will go up again and there will be speculation.

So I am predicting a moderate advance from now until a year from now. Then, if the war lasts longer, prices will go higher, but I don't expect inflation. America is not the place for inflation. After the war, if we have priorities, prices will rise some more. And I think it is perhaps desirable. At the end of the war we will have a tremendous debt—at least $75 billion, and more probably $100 billion. It will be hard to carry a debt of $100 billion at a price level such as we have now. Our debt was $26 billion at the end of the last war. I think that it is desirable to accompany a high National debt with a higher price level if the debt is to be carried at all.

Can we keep prices from rising during the next years? Yes. Will we? No. Why not? Because of pressure. The farmers say this is the time for them to get parity, and when they ask it they generally get it. I have every respect for Mr. Henderson, but the farmers of the country can get what they want through Congress, and they mean to have a higher price level. And their prices are food prices—things the working man has to have. We have the best mechanics for raising wages that we have ever seen—good labor unions, etc. You can't raise wages continuously without raising prices, or raise food prices without raising prices. Henderson can't do anything about it. If you did keep them down, under what conditions could it be done? The Germans have, practically, a watertight system. They give the public what they want it to have at fixed prices, and take the rest for defense. Yet those of you who read the *London Times* will see that they are having trouble in Germany keeping prices down. Unless you have a very tight system you can't keep prices down, and America will not have such a system. We will prevent inflation and have a moderate price rise. After the war we will have a moderate price rise.

FIFTH SESSION

SATURDAY, MAY 17, 1941 — 10:00 A. M.

Commerce Auditorium

Chairman:

WILLIAM F. MARSH, *C.P.A., Lybrand, Ross Bros. & Montgomery, Pittsburgh; Past President, The National Association of Cost Accountants*

Subject: "New Techniques in Management"

Speaker:

CHARLES REITELL, *Stevenson, Jordan & Harrison, Inc., Management Engineers, New York; Teacher in Accounting, Columbia University; Special Lecturer, Stevens Institute of Technology*

Subject: "Municipal Accounting"

Speaker:

HENRY M. KIMPEL, *C.P.A., Director of Finance, City of Cleveland Heights, Cleveland Heights*

INTRODUCTORY REMARKS

By William F. Marsh, *C.P.A.*
Lybrand, Ross Bros. & Montgomery, Pittsburgh;
Past President, The National Association of Cost Accountants

This is the fifth session of the Fourth Annual Accounting Institute at Ohio State University. I have had the privilege of attending all four, so I, like Dr. McLeod, am graduating this year. And I, too, hope that I shall be invited back, because I think, of all the accounting conferences held in connection with universities which I have attended, this one stands out.

We have two subjects today, and two excellent men to discuss them. The first speaker, I have known for a long time, since the days when he was an instructor in accounting at the University of Pennsylvania Wharton School. In 1919 he went to the University of Pittsburgh as head of the accounting department; along with many other activities, he was very active in the Pittsburgh Chapter of the National Association of Cost Accountants. In 1931 he left the University to become Director of the Pennsylvania Council. Now he is with Stevenson, Jordan & Harrison, of New York. His subject is "New Techniques in Management." I know of no one better able to present the subject than Dr. Charles Reitell.

NEW TECHNIQUES IN MANAGEMENT

By Dr. Charles Reitell
Stevenson, Jordan & Harrison, Inc., Management Engineers, New York; Teacher in Accounting, Columbia University; Special Lecturer, Stevens Institute of Technology

This morning I do not intend to analyze all of the headaches that beset present-day management and prescribe cure-all remedies. The rather narrowed phase that I wish to discuss is concerned with those disturbing problems of management that are inherent in the interplay of costs, prices and volumes upon net profits.

Perhaps you have never had to concern yourself with this interplay. Perhaps you have never faced rapidly changing price structures in a competitive industry where a mad rush to gain volume has often meant a slashing of prices and selling below costs. Yet, just to the extent that present-day management can quickly and accurately measure the effects upon net profit of changes in the cost, price and volume elements, just to that extent does management have control over the vital factors insuring the stability of the companies it attempts to manage.

Management has made some rather serious mistakes because it has lacked the necessary accounting methods for measuring price, cost and volume changes. It is not an uncommon thing to find management believing that by cutting prices 5 per cent all it has to do to compensate is to increase volume a like percentage. As a matter of measurement, however, we now know that "changes in price" is the most devastating, costs next, and volume last as affecting net profits.

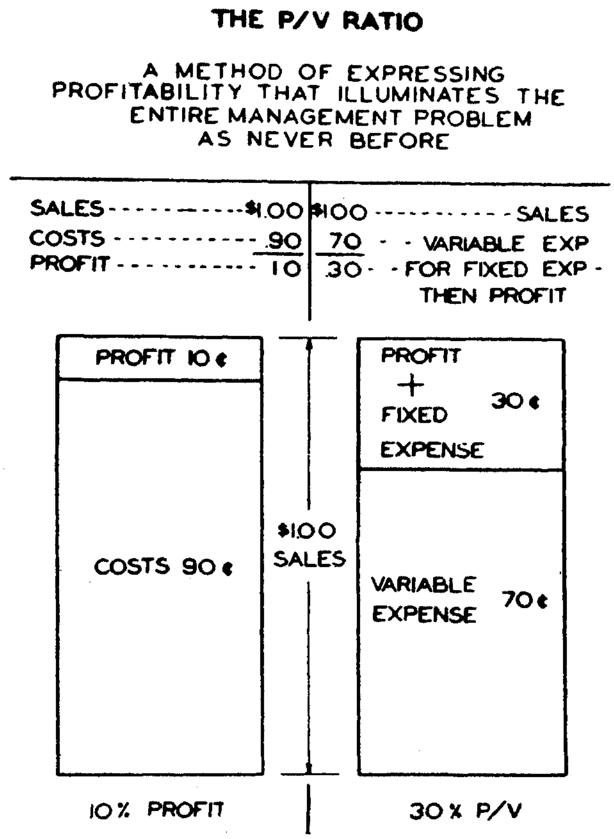
Our purpose today is to describe the tools and methods for accurately and quickly measuring the effects of price, cost and volume changes upon profits.

Time will not permit me to present all of the necessary techniques in complete detail. I will try, however, to cover the essential principles and to stimulate your thinking so that you will search and find the necessary refinements for applying the principles to your own companies. Understand the basic principles and concrete applications come readily.

Time handicaps me! Let us turn to Chart 1.

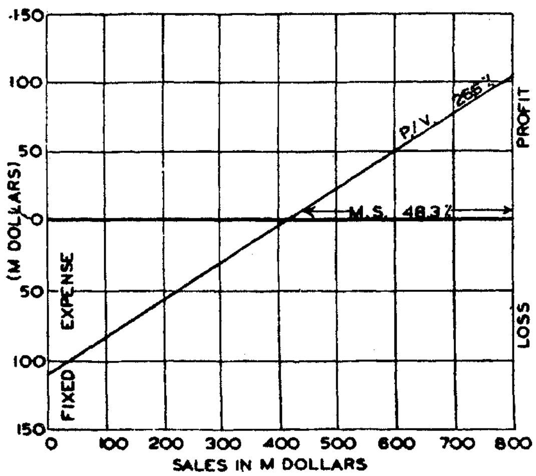
Here are shown two ways of expressing profit coming from the sales dollar. On the *left-hand* graph there is shown the traditional method; i.e., out of each sales dollar 10 cents is profit, or, as we express it, a 10 per cent profit on sales. In contrast, the graph to the *right* takes from the sales dollar all of the variable expenses (70 cents) and thus leaves a remainder (30 cents) that is available for meeting the fixed elements of expense and paying profit.

In short, take 30 per cent of the sales revenue and you arrive at the amount available for meeting fixed expenditures. After these fixed items are met, then, and only then, will profit start to accrue.



In Chart 2 the breakdown of fixed and variable expenses as shown in Chart 1 becomes a method of visualizing the influence of the cost, price and volume factors on profit. This company showed sales of $800,000, and out of every sales dollar, 73.4 cents were necessary for meeting the variable expenses, leaving 26.6 cents of the sales dollar for fixed expense and profit.

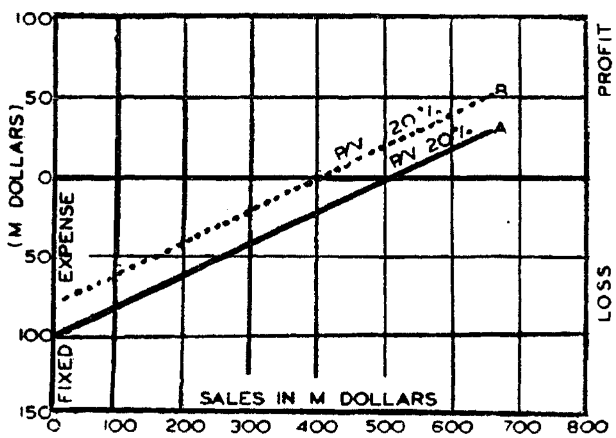
CHART TO VISUALIZE THE SIGNIFICANT FACTORS FOR A COMPANY WITH A SOUND CORRELATION OF BASIC ELEMENTS



DATA FOR YEAR 1939

(MONTHLY AVERAGES)

SALES		$800,000
FIXED EXP	$110,000	
VAR. EXP.	587,200	
TOTAL EXP.		697,200
PROFIT		$102,800
% PROFIT ON SALES		12.8%
SALES DOLLAR		$1.00
VARIABLE EXPENSE		.734
LEFT FOR FIXED & PROFIT		.266
OR A P/V OF		26.6%
BREAK-EVEN POINT		$413,500
MARGIN OF SAFETY.		48.3%

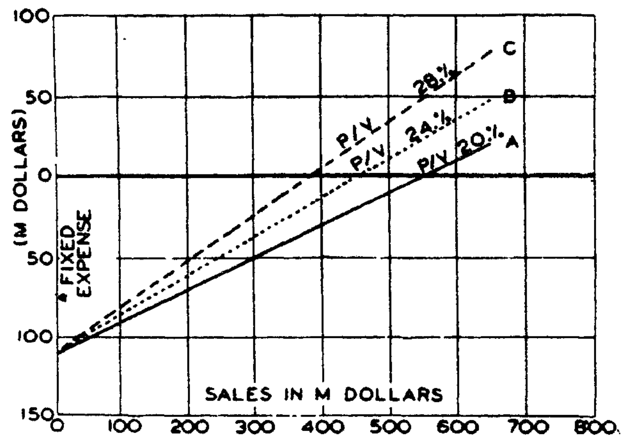


SOLUTION THROUGH REDUCING FIXED EXPENSE

	A	B
GROSS SALES	$650,000	$650,000
FIXED EXPENDITURES	$100,000	$ 80,000
P/V	20 0%	20.0%
BREAK-EVEN	$500,000	$400,000
NET PROFIT	$ 30,000	$ 50,000
NET PROFIT %	4 6%	7 7%

On the vertical scale are indicated the fixed expenses of $110,000 (left-hand side of chart); also on this same scale there is shown the net profit of $102,800 (right-hand side of chart). By connecting these two points we establish the profit-volume path of fixed absorption and profit making in terms of the sales volume shown on the horizontal scale. This profit-to-volume path expressed as P/V thus sets forth the effect of any change in volume, cost and price structure.

If costs and prices remain constant, then any change in sales volume is shown on this chart without further calculations.



SOLUTION THROUGH REDUCING VARIABLE EXPENSE

	A	B	C
DOLLAR OF SALES VALUE	1.00	1.00	1.00
VARIABLE COMPONENT	.80	.76	.72
BALANCE FOR FIXED & PROFIT	.20	.24	.28
P/V RATIO	20%	24%	28%

A - ORIGINAL POSITION
B - REDUCTION OF 5% IN VARIABLE COMPONENT
C - REDUCTION OF 10% IN VARIABLE COMPONENT

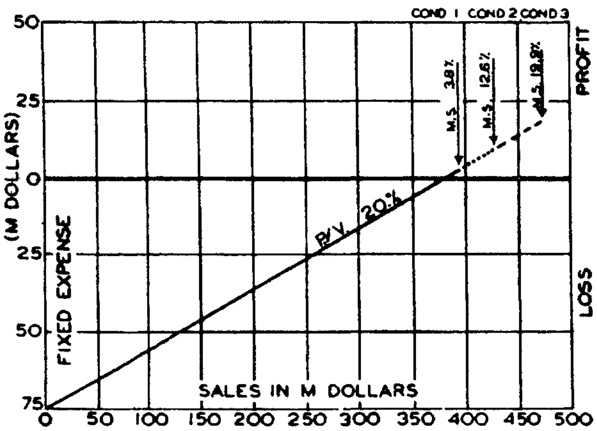
	A	B	C
GROSS SALES	$650,000	$650,000	$650,000
FIXED EXPENDITURES	$110,000	$110,000	$110,000
NET PROFIT	$ 20,000	$ 46,000	$ 72,000
NET PROFIT %	3.08%	7.08%	11.08%

Our next step is to calculate the influences that come from changes in costs. These changes take place either in the reduction of the fixed expenses or in the variable expenses.

Chart 3 gives the method of measuring the effects that come from reducing the fixed expense. The illustration shows a reduction of fixed expense from $100,000 to $80,000. The dotted line is the resulting profit-volume path.

Inasmuch as no change is assumed in variable expenses, the available amount from the sales dollar for fixed expenses and for profit remains the same, i.e., 20 cents. By savings in the fixed items, however, greater profit is made possible—starting at $400,000 sales volume instead of $500,000.

In Chart 4, there is given the solution of management's cost problems that is obtained through a reduction in the variable expenses. When the variable expenses are lowered then there remains a larger share of the sales dollar for fixed expense and profit. Another way of stating the principle



	CONDITION #1	CONDITION #2 10% INCREASE IN SALES VOLUME	CONDITION #3 20% INCREASE IN SALES VOLUME
SALES VOLUME	$ 390,000	$ 429,000	$ 468,000
FIXED EXPENDITURES	$ 75,000	$ 75,000	$ 75,000
BREAK-EVEN POINT	$ 375,000	$ 375,000	$ 375,000
P/V	20%	20%	20%
NET PROFIT	$ 3,000	$ 10,800	$ 18,600
NET PROFIT %	77%	2.32%	3 97%

SOLUTION THROUGH MORE SALES VOLUME

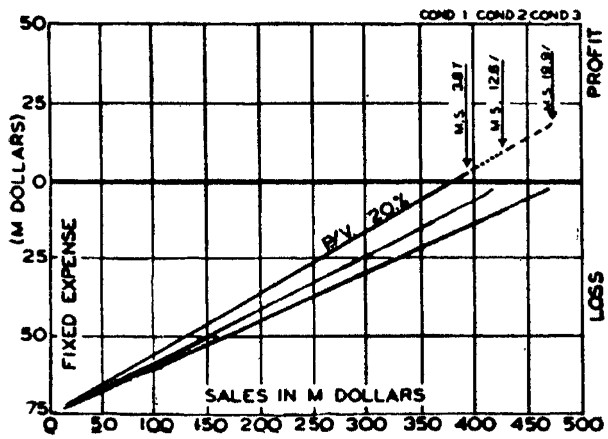
is that, as variables are improved, the faster sales revenue is enabled to absorb fixed expense, and thus build profit.

In the chart, variables have been reduced from 80 cents in Case A to 76 cents in Case B and to 72 cents in Case C. Note how these changes hasten the absorption of fixed expense. A reduction of 10 per cent in variables means that the break-even point drops from $550,000 to $380,000. It indicates also that profit increases from $20,000 to $72,000.

Catch, if you will, the quickness with which these determinations can be made. Especially is this speed of great value when the calculations have to do with some division of the company, such as a particular sales territory or some specific delivery route.

Chart 5 shows the effect of increased sales volume without any changes indicated in price or costs. This means that the P/V is simply extended to the total revenue, with the corresponding resulting profit read on the vertical scale. Note, however, that the margin of safety has been greatly improved by virtue of the added volume.

Chart 5 must be interpreted, however, in most practical experiences, with changes in selling prices.



SOLUTION

THROUGH

MORE

SALES

VOLUME

	CONDITION #1	CONDITION #2 10% INCREASE IN SALES VOLUME	CONDITION #3 20% INCREASE IN SALES VOLUME
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P/V	20%	20%	20%
NET PROFIT	$ 3.000	$ 10.800	$ 18.600
NET PROFIT %	.77%	2.52%	3.97%

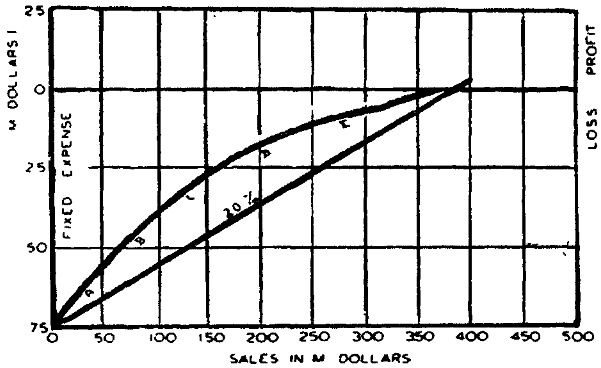
Chart 6 shows what happens when more sales volume is obtained by cutting prices. Or shall I say that it portrays the curse of destructive competition where greater sales are built by "stealing" volume from others.

In this illustration the added sales were obtained by like percentage cuts in prices. Note that in both cases no profit was possible, because the gutted price structure was not sufficient to absorb the fixed expense.

Chart 7 merits your careful study. After working in these principles to the extent that you appreciate their import, you cannot help catching the practical value that comes with their application to different divisions of the company. In this chart the emphasis is placed on different lines of products. Taking five lines of products we readily see that, when charted, the P/V of Product A is so good that, if all the sales were in this line, then profit would start to be earned at less than $200,000 of sales. In contrast, if only Product E were sold, it would take over $1,000,000 of sales before the fixed expenses were absorbed.

What is shown here is for product-sales determination, but it illustrates a principle which can be applied to different salesmen, sales territories or routes of delivery.

All of the above measurements are comparatively simple to calculate *provided* your accounting system gives the needed information. There is



SOLUTION THROUGH SELECTIVE SELLING

		I	II
CLASSIFICATION BY			IMPROVED
DEPARTMENTS	A		$ 63 000
PRODUCTS	B		61 000
TERRITORIES	C		81 000
SALESMEN	D		108 000
ACCOUNTS	E		77 000
TOTAL SALES			$ 390,000
MARGIN OF SAFETY			16.4 %
NET PROFIT			$ 14,700

the rub. Most accounting systems are so absorbed in writing history of what has happened that they have failed rather badly in providing management with the tools needed for measuring present and future procedures.

If the above principles are to be made effective, we accountants must make some rather basic changes, both in our thinking and in our methods. Yet, at the same time, we must in no way weaken our present systems of balance and control.

The behavior of the expense and cost accounts is the important phase of this newer approach which has been neglected.

How do accounts behave at different ratios of activity?

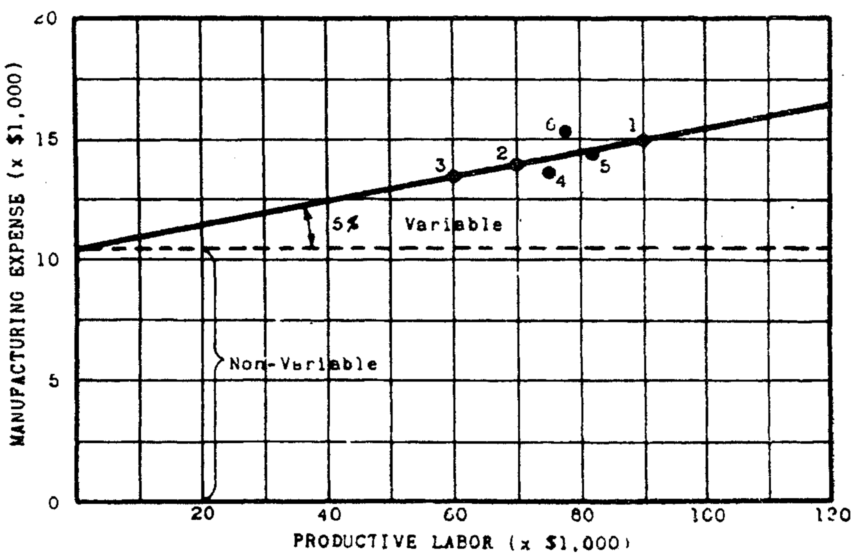
How shall we set up analyses to record properly variable and fixed costs?

How shall we break down the semi-variable and curved accounts into their fixed and variable components?

These are but a few of the accounting problems that must be met if the principles are to become standard practice.

Chart 8 gives the method of separating a variable account into its fixed and variable components. Each dot gives the expenditure for manufacturing expense in terms of the volume of productive labor. The heavy

DETERMINATION OF FIXED & VARIABLE ELEMENTS OF EXPENSE



trend line then gives the variability of the expense. Likewise, the non-variable or fixed component is calculated. If mathematical accuracy is required, then the slope of the heavy line is obtained by applying the principle of least squares.

In conclusion, the technique set forth today is not entirely new. Long since we have developed break-even charts and profitographs. The refinements shown today, however, are new. To me they indicate a method for the practical solution of management's problems that heretofore has been missing.

Only as we accountants catch the need of management for a more accurate tool for quickly measuring the interplay indicated here, and only as we see how faulty many management policies have been because they lacked this technique, then will we begin to realize and attempt to improve our accounting procedures.

If I have by this technique started you thinking in newer channels, then I feel certain of the outcome. You, too, will begin to search into the way your accounts behave under the heavy blows of price, cost and volume changes. And you, too, will realize that a new technique is on the horizon that will soon enlighten the understanding of management in one of its most difficult problems.

CHAIRMAN MARSH: Thank you, Dr. Reitell. Are there any questions? Dr. Reitell's talk reminded me of the story of the little old lady who bought apples at 1 cent apiece and sold them 6 for 5 cents. Someone asked her how she managed to make a profit that way, and she said because she sold so many of them.

If there are no questions, we will continue with the program. Our next speaker has a very interesting subject. Mr. Henry M. Kimpel is a member of the Ohio Society of Certified Public Accountants. He was with Warner and Swasey, of Cleveland, as Assistant Treasurer, until he became Director of Finance for the City of Cleveland Heights, Ohio, and has been extremely active in that capacity. Without saying more I am pleased to present Mr. Henry M. Kimpel.

MUNICIPAL ACCOUNTING

By HENRY M. KIMPEL, *C.P.A.*
Director of Finance, City of Cleveland Heights,
Cleveland Heights

The financial administration of a municipality must conform with the legal provisions under which the municipality is governed. These provisions call for the establishment of various Funds, so as to segregate their use according to law.

For the definition of the word "Fund" as used in municipal accounting, I refer to The Municipal Finance Officers Association, which says:

> A Fund may be defined as a sum of money or other resources set aside for the purpose of carrying on specific activities or attaining certain objectives in accordance with special regulations, restrictions or limitations and constituting an independent fiscal and accounting entity. It will be noted that a Fund is both a sum of resources and an independent fiscal and accounting entity. Each fund must be so accounted for that the identity of its resources and obligations is continually maintained. Also, the receipts and disbursements and the revenue and expenditures must be identified with the funds to which they apply. The purposes are accomplished by providing a complete self-balancing set of accounts for each fund showing its assets, liabilities, reserves, surplus, revenue and expenditures.

To distinguish this from the commercial use of the word "Fund," we find in that field that a Fund is used to designate merely an earmarked sum of money or other resources, and no complete self-balancing group of accounts is provided.

The Funds shall be classified so that they are established pursuant to State Statutes, Municipal Charter requirements, or under the provisions of ordinances, or for good-business reasons.

The National Committee on Municipal Accounting recommends the following classification of Funds:

General Fund
Special Revenue Funds
Working Capital Funds
Special Assessment Funds
Utility Funds
Bond Funds
Sinking Funds
Trust and Agency Funds

This probably represents the maximum number of Funds needed by any municipality, and many cities will use only a few of them. However, every municipality will have a General Fund.

One is reminded in this classification of Funds of an accountant who is employed to keep the accounts of a group of establishments on "Main Street." Let us assume his clients are: a general department store; a public utility, such as a light or water plant; an investment company; etc., etc.

Certainly he would keep complete balancing Funds for each business, and in no way combine the assets or liabilities, income or expense of one concern with those of another. Yet in the municipal field we often find the fiscal officers violating this important role.

It must be remembered that the foregoing Funds represent "types" of Funds and that some cities require several Funds of one type. For instance, the General Sinking Fund may consist of any number of sinking Funds, each accumulating resources to pay a particular bond issue at maturity. We might call these "related funds" and therefore group them in one Sinking Fund in the ledger. The basis of accounting may vary among different types of funds but the same basis and procedure will apply to each of the "related funds." In spite of this, each Fund in the group is considered an independent entity.

BUDGETING

The establishment of Funds insures that the money will be expended for the purposes for which it is dedicated. It becomes necessary to know the maximum amount of expenditures which may be made out of the Fund during the year or for a particular purpose, together with the portion applicable to each of the many activities financed by that Fund, and the cost of the various objects under each activity. Since the expenditures must be limited to the amount of revenue available to finance them, it becomes necessary to make an analysis of the revenue and the source from which derived. In other words, the budget is an estimate of the proposed expenditures for a given period or purpose and the means of financing them.

APPROPRIATIONS

The Budget is the instrument used by the budget-making authority in presenting the financial program to the appropriating body, and contains information as to past and proposed expenditures and revenues. The budget is the managerial device put into effect through legal action.

The expenditure side is enacted into law through the passage of an appropriation ordinance, and the legal basis of the revenue side is by the levy of taxes and passage of ordinances.

In Ohio we are having our share of problems in the making of budgets and in arriving at the amounts of revenue available for appropriations. We are required to file our budgets with the County Budget Commission in July of each year for the operation of the following year. In Cuyahoga County we do not receive our first-half tax settlements for the current year until the month of August, so that we are required to estimate next year's outcome with no knowledge of the possible outcome of the current year. It is true that we borrow money during the first few months of each year in anticipation of the collection of taxes, also, that we may receive advances from the county as the taxes are being collected, but not until the first-half of the current year has passed do we know just what our revenues have been.

Many of the cities in Ohio made budgets in July, 1940, for their operations in 1941, in which were plans for the refunding rather than the payment of their bonded debt, or part of the debt. The Refunding Act under State law expired January 1, 1941, and the legislature did not re-enact this law until March, 1941, so that the cities had no knowledge until then of the amount of revenue available for the current year from this source. Our local county budget commission, whose duty it is to allocate the "Intangible Taxes" of our county among libraries, municipalities, etc., could not make such allocation before January 1, 1941, because a case involving the prior year's distribution had not been heard in the State Supreme Court. Is it any wonder that some cities have no credit standing when their resources are determined "by guess and by gosh?"

ACCOUNTING SYSTEM

The Accounting System is the controlling device which insures that the budget plan will be put into effect. It provides that each commitment of expense be charged to the proper appropriation account as an encumbrance, and no purchase order or contract can be placed until it bears the approval of the fiscal officer, and it must show the estimated cost involved. When the goods and the invoices are received, an entry is made to adjust the balances in the appropriation by the difference between the estimated expenditure and the actual amount of the bill.

In one Ohio city it was customary to have two appropriation records, one which tied in with the ledger and to which only paid invoices were charged. The other was a memorandum appropriation record, consisting of columns headed by the total appropriation amount and to which each estimated encumbrance was charged, and sub-totals were brought down for monthly encumbrances and appropriation balances. When the actual-expenditure amounts were available, all previous entries and balances were corrected by erasure. If you have seen one of the paper targets used in a shooting gallery after target practice, you have a good picture in mind of *that* particular appropriation record.

CASH AND ACCRUAL BASES OF ACCOUNTING

Each municipality in Ohio completes two reports as furnished by the Auditor of State, in which they state in detail all of the receipts and disbursements, by funds, during the past year. In order to comply with this requirement, it is necessary to keep records on this basis; namely, the Cash Basis. We can readily appreciate the weakness of a city keeping its financial records on the cash basis—recording an expense only when it is paid. The memorandum appropriation record mentioned above is an attempt to overcome this weakness, as this record, if properly maintained, would show the remaining appropriations after all commitments were charged, whether paid or not. The fiscal officer of one of the large Ohio cities told me when he took office that he had found over $10 million of commitments that were not recorded as such. Had these books been kept on the Accrual Basis, such encumbrances would have been impossible. Under the *accrual* basis, revenues are taken into the accounts as soon as earned, regardless of when they are collected, and expenditures are reflected as soon as the liabilities therefore are incurred. On the other hand, under the cash basis, revenues are taken into the accounts only when collected, and expenditures are so regarded when the money is paid out. Because of taxation methods in Ohio, my preference is to handle our accounts partly on the cash basis and partly on the accrual basis. By that I mean that we handle our revenue on the cash basis, posting same to the books when actually received, while our encumbrances are charged to appropriation as soon as incurred. This is even more conservative than the complete accrual method. There are a number of reasons for this:

In Ohio each taxing district (county, municipality, school) establishes its own tax rate. These are then combined in one rate by the county auditor who levies the tax and distributes the tax, when collected, proportionately. The unpaid or delinquent taxes, according to the custom of most county auditors in Ohio, are not earmarked and are merely allowed to accumulate as a total sum of delinquent tax against the property. When this delinquent tax is collected it becomes part of the current year's tax collection and is distributed to the taxing districts in proportion to the current year's tax rate. So that, if a city in 1935 levied a tax rate of 60 cents per $100, out of a total tax rate of $2.40 per $100, it would receive

60/240's or ¼ of the entire general-tax collection. If, however, some of this levy went delinquent and was collected in 1940 when the city levied only 40 cents per $100 out of a total rate of, let us say, $2.80, then this delinquent collection would be distributed as 40/280's or 1/7 to the city. In other words, the taxes as levied, when they become delinquent, are not an asset of the district which levied them.

This is further complicated by the fact that if the original 60 cents was made up of 40 cents for debt retirement and 20 cents for operating, and collected when levied, then the sinking fund would receive its share of the levy (40 cents), but if collected as delinquent taxes years later, when possibly the debt levy is only 10 cents and the operating levy 30 cents, then the sinking fund would never receive the proper amount of taxes to meet its requirements.

	1935	*1940*
City—debt	$ .40	$ .10
oper.	.20	.30
	$ .60	$ .40
School	1.30	1.80
County	.50	.60
	$2.40	$2.80

Therefore, the reservoir of delinquent taxes cannot be considered as a good asset on the books of the municipality, and the fund for which the city levied the tax may never be the recipient when the delinquent tax is paid.

On two occasions in the last few years, the legislature of this state passed laws which provided that all delinquent general real-estate taxes collected in the county were to be held in a special fund of the county and distributed to districts which had issued bonds for which delinquent taxes were pledged and to districts which owed large contractual debts. I was told that this referred particularly to street-lighting bills owed by municipalities. Since this deprived the schools of this state from receiving their share of delinquent taxes, they promptly had this law repealed. The following year, the same law was passed with the amendment "except delinquent school taxes;" the municipalities then stepped in and had the second law repealed. You can readily understand why I prefer to record our revenue only when it has been received—not as it accrues.

ACCOUNTS

Municipal accounts may be classified in each fund, as balance-sheet accounts and operating accounts. The balance-sheet accounts consist of the assets and other resources, liabilities and surplus of the particular fund. The operating accounts consist of the revenue and expenditure accounts, which reflect the changes in the financial condition of the fund.

The National Committee on Municipal Accounting has issued a Bulletin No. 9, *Standard Classification of Municipal Revenues and Expenditures*. There we find that the primary classification of revenue is by "source"—i.e., General Property Taxes, Other Local Taxes, Licenses and Permits, Fines, Penalties, etc., with further supplementing divisions as to departments. Expenditures are classified by function, activity, organization unit, object and character. Much is to be done by the municipalities to improve their classifications of accounts in order to be able to produce balance sheets and operating statements as recommended by the National Committee on Municipal Accounting. Every municipal fiscal officer should be supplied with the publications of this Committee and of the Municipal Finance Officers' Association, which have done more to improve governmental accounting than have any other such associations. Many public fiscal officers have been criticized for their inefficiency, and often rightly so, but on the other hand the public probably does not know that, in Ohio, membership fees in any organization such as this, also books, publications, and meetings of these organizations, cannot be paid for from city funds.

COST ACCOUNTING

An essential element of a comprehensive municipal accounting system is a system of cost accounting in which it is possible to determine the cost of various operations by departments. It would provide for the handling of materials through a central control, and include proper time and pay roll records. These cost records should be constantly balanced to the control accounts maintained in the General Ledger. To make this fully effective it would necessitate a complete double-entry system of the general books. I would guess that in Ohio less than 20 per cent of our cities keep records of the double-entry system, and probably a smaller per cent keep their books on the accrual basis. Probably less than 5 per cent have any information as to the value of their assets, which would be necessary in order to make a proper and complete balance-sheet. One of the essentials of a good municipal accounting system is that all accounts should be centralized under the direction of one officer. This is not done in many cities of this state.

I have made many references to methods employed by Ohio cities because of the place of this meeting and because Ohio fiscal officers have been invited to attend. Probably we can defend ourselves here from the criticism often directed at us. Fundamentally, the public and our legislature think in terms about like this: "We want our tax spenders to receive only so much money this year and we want to know at the end of the year just how it was disbursed." Isn't it true that possibly this thought was the reason for keeping municipal records on the "cash basis?" Then they said, "when you finish this year we want you to report your cash balances so that next year's requirements will be partly provided for." In other words, "you cannot set up any Reserves for the rainy day"; they arranged it so that the State Auditor's office examines our books each year and provides a uniform report for us to fill in—all of this on the "cash basis"; the legislature provides laws which state that we cannot spend city funds to broaden our knowledge of municipal accounting; the tax payers tell us our salaries are too high—without the additional allowances for traveling expenses to conferences, etc.; other selfish groups create lobbies which encourage the passage of laws so that municipalities must have a 65 per cent vote of the people to create debt or other levies while all other levies require only a majority vote; and the libraries were successful in having the classified property tax law passed, which, when the tax is distributed, gives them the preference of receiving their entire budget amount at each half-year settlement, while the cities receive their share only as general creditors of the remainder.

Even the banks helped in the passing of a Depository Law in Ohio, so that we are to keep our funds in the various banks of our town so that they are divided in proportion to the capital of each of the banks. This definitely interferes with the Fund accounting system which is paramount. I've already mentioned other lobbies which, on two occasions, have put laws on the books of this State which attempted to take away from the cities the delinquent taxes rightly due them. Every year for the past five years, our city has been compelled to use the courts, and several times the State Supreme Court, to receive the revenue to which it was entitled. These remarks refer more particularly to municipal financing rather than to municipal accounting, but these are difficult to separate.

From these remarks you can judge the difficulty in Ohio in attempting to keep books on the recommended "accrual basis" or recording assets for balance-sheet purposes or making intelligent budgets or establishing a system of cost accounting, but progress *is* being made. Eight years ago three State examiners in my office objected to the proposed installation of a new double-entry system of accounting, on the accrual basis, using a bookkeeping machine. Since then one of these examiners has been instrumental in installing the same system in two other Ohio cities. Another important point in the installation of any municipal accounting system is "simplicity." I have here a sample appropriation account on a bookkeeping machine, which was installed in Miami, Florida. This one account is for "Repair Parts" in the Police Division of the Public Safety Department, and contains thirteen columns of figures to record this kind of expense. I think it is a fine example of the possibilities of the machine and appears to be a fine job of selling but a poor job of bookkeeping. This is typical of the kind of installation that remains as long as the present administration is in office, but probably will go out with the next election.

This brings me to my final thought on the subject assigned to me, and that is "continuity of government." I have brought a few copies of the latest financial reports of our City with me, and there are several items I would like to call to your attention. On page 3 is shown the service record of our seven councilmen, who now average 21 years each. The longest service of one councilman is 31 years. The effect of this continuity of government is pointed out best on page 6, where is shown the debt reduction record of 86 per cent over the past 15 years. A city may install a perfect municipal accounting system, and yet a change of administration may ruin many years of fine work by an able fiscal officer. It is for this reason that I mention this point.

CHAIRMAN MARSH: I think you will all join me in thanking Mr. Kimpel for an excellent paper. Are there any questions?

MR. K. K. MORRIS (Cleveland, Ohio): On page 11 of your Analytical Financial Report, eleven funds are listed. You mentioned that the law requires you to place money in banks according to the ratio of their capital. Do you have 33 bank accounts, assuming three banks?

MR. KIMPEL: According to the depository law we designate all of our funds as "active" funds and none as "inactive." The banks are reluctant to accept for deposit any municipal funds, since they are required to pledge collateral in excess of the deposit. One bank limits our deposits to $100,000 and the other bank has accepted the remaining ten funds. Because of the maximum deposit, I was required on one occasion to withdraw $350,000 in cash and deposit it in a special safety-deposit box. The municipalities should not be compelled to break up deposits by the size of banks; this division should be made by funds only. I feel that each municipality should have a separate bank account for each municipal fund, although many municipal men will disagree with me. To support this contention I would refer you to the financial report of December 31, 1933, of the City of Youngstown, Ohio, in which are listed the remaining balances at the end of the year for fifteen different funds. About half of these funds had balances—one of them a balance of over $1,100,000. The remaining seven funds were deficits, and the combined cash balance of all funds was only $12,600. I do not know whether anyone has gone to jail in Youngstown or not.

QUESTION (From the floor): You keep two sets of books—one for cash and one for appropriations?

MR. KIMPEL: For the State Auditor's office we are obliged to file, at the end of each year, its regular form of cash receipts and disbursements. For our eleven funds we have a complete set of records annually. The opening entries for each fund are, the assets—namely, the cash balance, a conservative estimate of the total of "other resources"—and, on the liability side, the accounts payable; the difference between the assets and liability or the surplus is the amount set up as the annual appropriation for the year. We charge to our appropriation account each commitment as it is incurred, and we constantly maintain balances in our detailed appropriation accounts, cash accounts and accounts payable. The posting of our commitments constitutes the accrual basis. We hold our books open until all such encumbrances have been paid, which then brings our records to the cash basis. Any commitments for which invoices have not been received are carried over as new encumbrances in the following year.

MR. REITELL: Do you have any deficiency appropriation? In Pennsylvania we can spend more than we are allowed and the Legislature will pass more the next time to cover it.

MR. KIMPEL: As far as I know we have had a red figure in our accounts only once in the past ten years. I believe in Ohio there have been many cases of cities operating under a deficit, which have later issued deficiency bonds to cover it.

QUESTION (From the floor): I know that the City of Cleveland Heights is exceptionally advanced in its practices and is cooperative with its citizens. How many other city-manager type of cities take the time and trouble to issue a financial report?

MR. KIMPEL: In 1924 our city compiled a comprehensive report, and the entire cost was about $2,000. We thought we were doing a worth-while job but we found the examiner had charged us with an illegal expenditure of $2,000. We are obliged to publish the annual state report of receipts and disbursements in a local newspaper, but to the average layman these are of very little value. The greatest use of our Analytical Financial Report is for credit purposes. Bond houses are continually asking cities to fill in their prescribed reports. Our report follows closely the recommendations of the Investment Bankers Association. At each bond sale these reports are sent to all prospective bidders. The annual cost for the printing of this report is $50. I know of two or three other cities having similar reports.

MR. W. A. ROWE (Cleveland, Ohio): It might be of interest to those of you from the City of Cleveland to know that Cleveland gets out reports. In the *City Record* each year we publish complete receipts and disbursements, by departments and divisions. If I were a large manufacturer in Cleveland, I would send $1.50 to the City Clerk and buy the *City Record*. You would know more about government if you did this. It is published and complete, and gives a very good picture of the city.

MR. SHONTING (Ohio State University): I would like to point out that in Cleveland Heights you are working with the city-manager type of government. In Ohio we have almost every form of city government, and we have one of the worst political situations when it comes to effective administrative control. In Ohio we do not trust anybody. We elect to practically every office. And when the accountant goes in, the incumbent says, in effect, "I am only responsible to the people."

MR. ROWE: I would like to have Mr. Kimpel tell about the State Auditor's office.

MR. KIMPEL: The subject of auditing municipal accounts should be followed up, as it "needs much doing." These are the words as used in the editorial in the May *Journal of Accountancy*. It might be well for our Ohio society of C.P.A.'s to become more active on this subject, and possibly the Research Department of this university could do some effective work on how municipal accounting should me handled in this state. We find in the State Auditor's office that this work has been done in the same manner for the past forty years and the cities are apt to be criticized if they vary from the old practice. Many of the examiners on the State Auditor's staff are capable men, and it has been interesting to notice that, because our city is using a double-entry method on the accrual basis, the better class of examiners are sent out to check our records.

The municipal finance officers in this state have tried for the past six years to get the Legislature to pass an act enabling municipalities to join an organization of municipal officers so that there may be an interchange of information and a united effort for the improvement of municipal accounting and reporting. Recently this proposed bill passed the House, but I understand that it died in the Senate Rules Committee.

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